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United States General Accounting Office

Report to Designated Congressional  
Committees

# TAX POLICY AND ADMINISTRATION

## 1989 Annual Report on GAO's Tax-Related Work



94-23382



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General Government Division

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March 16, 1990

The Honorable Dan Rostenkowski  
Chairman, Committee on  
Ways and Means  
House of Representatives

The Honorable Lloyd Bentsen  
Chairman, Committee on  
Finance  
United States Senate

The Honorable Lloyd Bentsen  
Chairman, Joint Committee on  
Taxation  
Congress of the United States

The Honorable John Conyers, Jr.  
Chairman, Committee on  
Government Operations  
House of Representatives

The Honorable John Glenn  
Chairman, Committee on  
Governmental Affairs  
United States Senate

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This report is submitted in compliance with 31 U.S.C. 719(d) and summarizes GAO's work on tax policy and administration during fiscal year 1989. It includes information on legislative actions taken as of December 31, 1989, on GAO's recommendations, recommendations to Congress made before fiscal year 1989 that remain open, and assignments for which GAO was authorized access to tax information under 31 U.S.C. 713.

Until now, the annual report was prepared on a calendar year basis. Beginning this year, the report will be prepared on a fiscal year basis to better ensure that information in the report is available to Congress when it begins its annual oversight and appropriations cycles.

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## Key Recommendations for Tax Policy and Administration in 1990

The products GAO issued in fiscal year 1989 discussed specific congressional and administrative actions to increase federal revenues, enhance the effectiveness of tax incentives, improve compliance with the nation's tax laws, and improve the Internal Revenue Service's (IRS) management effectiveness.

### Increase Revenues

Many have suggested that a credible strategy for reducing the federal deficit must include some revenue increases. GAO analyzed options that could be considered as Congress deliberates the revenue side of the deficit reduction equation including:

- Adjusting the federal excise taxes on such products as alcohol, tobacco, and certain weapons to keep pace with inflation would raise an additional \$12 to \$75 billion over a 5-year period. Some of the per unit dollar amounts of these excise taxes have remained the same for over 3 decades in spite of the significant price changes experienced during this time. Although some argue that the relative burden of excise taxes is borne more heavily by low-income people, the evidence, although inconclusive, suggests that the taxed commodities are discretionary purchases disproportionately consumed by higher income groups. (See p. 44.)
- A value-added tax on consumption is often suggested because of its revenue potential—about \$125 billion annually at a 5-percent rate applied on most goods and services. The United States is the only industrialized nation without some kind of broad-based national consumption tax. GAO's study of other nations' experiences suggests that a federal value-added tax linked to the broad consumption base of the nation's economy would provide a significant and stable source of revenue with relatively small percentage rates that would not tax savings as the current income tax does. The disadvantages of a broad-based value-added tax include (1) its regressivity, because lower income people use more of their income for consumption, and (2) the administrative and compliance issues posed for tax administrators as well as businesses. A value-added tax, however, could be designed to mitigate some of these concerns. For example, necessities such as food and health care could be exempted from the tax to ease the burden on lower-income families. To the extent that necessities are exempted or multiple rates are introduced, a value-added tax would need to be structured using a more complex method of calculation. (See pp. 45 and 47.)

## Enhance Effectiveness of Tax Incentives

Tax preferences and incentives are often adopted by Congress to foster certain policy goals, such as improving access to housing or promoting employment for lower income workers. In 1989, over 120 tax preference items accounting for over \$300 billion in revenue foregone remained in the tax code, despite continuing concerns that they frequently are not well targeted at intended beneficiaries and that the subsidized activities would have been undertaken anyway. GAO suggested improvements to several tax incentives to enhance their effectiveness including:

- The research and experimentation tax credit cost over \$7 billion in federal tax revenues but only stimulated between \$1 billion and \$2.5 billion of additional research spending. More research per federal tax dollar would be stimulated by restructuring the credit to reward firms for increasing their spending above a fixed-base amount that is adjusted for inflation. Congress enacted a revised fixed-base credit that will be effective for the first 9 months of 1990. If Congress decides to make this credit permanent, it should provide for periodic adjustments to the base as a means of reducing the amount of the credit earned for research expenditures that firms would have made without the credit. (See p. 75.)
- According to estimates by the Joint Committee on Taxation, between \$400 million and \$500 million in federal tax revenues are foregone to subsidize employers who provide educational assistance to their workers under section 127 of the tax code, which was recently extended through September 1990. However, adequate information is not available to evaluate whether the benefits of this tax expenditure are targeted to those needing it the most. To help assess the effectiveness of this program, GAO recommended that Congress consider requiring employers who use this provision to report such things as the average income of participants and the average benefits provided for various salary levels. (See p. 72.)

## Improve Compliance

Compliance with the nation's tax laws persists as a significant problem that costs billions of dollars in lost federal revenues. IRS estimated taxpayers would not pay \$87.1 billion in income taxes owed the government in 1988, an amount that could grow to nearly \$114 billion by 1992. GAO identified a number of enforcement initiatives to enhance IRS' effectiveness, some of which require congressional action:

- Major tax losses occur when employers misclassify their workers as independent contractors because employers do not withhold income taxes from them and independent contractors are more likely than

employees not to report all of their income. For example, IRS estimated that sole proprietors, many of whom are independent contractors, accounted for \$16 billion in unpaid income taxes for 1987. GAO identified a systematic approach for IRS to identify employers likely to misclassify workers. Although IRS has agreed to implement this approach, its effectiveness will be seriously hampered by section 530 of the Revenue Act of 1978 which prevents IRS from reclassifying many contractors as employees. For example, IRS' most recent estimate shows a revenue loss of about \$111 million associated with section 530. GAO recommended that Congress modify this section to permit IRS to require employers to prospectively reclassify employees who have been misclassified as independent contractors. (See p. 32.)

- More effective civil tax penalties can deter noncompliance and help reduce the gap between taxes owed and taxes paid. As part of the Omnibus Budget Reconciliation Act of 1989, Congress reformed key penalties for such things as underreporting tax liability and failing to file information returns and tax returns. The act made a number of improvements, but some of its provisions seemed to reduce the incentive to comply. For example, the act reduced penalties applied to taxpayers who understate their tax liabilities by more than \$5,000 and eliminated the only penalty applied to taxpayers who fail to report income disclosed on information returns. In a report on options for civil penalty reform, GAO recommended, among other things, that Congress retain the latter penalty and strengthen the understatement penalty. (See p. 40.)
- According to its statistics, IRS annually gains about \$3 billion in revenues through the computer matching done as part of its information returns program. GAO believes that millions of dollars in additional revenues could be obtained if more information returns were filed. For example, GAO found that the state and local governments it visited filed information returns on only about 10 percent of the contractor payments they should have reported and IRS' examination program is not effectively identifying the many businesses that fail to file required information returns. Perhaps even greater revenue can be realized from IRS' adoption of a document matching program for payments to corporations and partnerships. While the revenue impact from having this program is uncertain, revenue estimates have ranged from \$300 million to \$8 billion. GAO is currently monitoring IRS' study of this issue. (See pp. 29 and 31.)

## IRS' Management Effectiveness

The successful implementation of these and other tax administration initiatives critically depends on IRS' organizational capacity and competence. In fiscal year 1989, GAO and IRS completed a major study that

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provided a managerial agenda for the future. The study identified several major challenges facing IRS including the need to modernize the agency's outdated tax processing system, update critical accounting and financial systems, and strengthen human resources. (See p. 50.)

IRS is beginning to make some of the major changes in executive leadership, planning, and accountability called for in that report, and GAO will be issuing a status report on IRS' progress. GAO is also closely monitoring the modernization of IRS' information and tax processing systems. Several reports and testimonies addressed problems with the agency's cost estimates, the integration of system components, and the tracking of projects within the modernization effort. (See pp. 14, 16, 18 and 20.)

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## **Actions Resulting From GAO's Reports**

Various congressional committees and Members of Congress used GAO's products in overseeing tax administration operations, considering tax policy issues, and enacting legislation. The Technical and Miscellaneous Revenue Act of 1988 and the Omnibus Budget Reconciliation Act of 1989, for example, addressed several issues raised in our reports on such matters as life insurance taxation, tax-exempt bonds, and civil penalties.

IRS has taken, or plans to take, action on most of the recommendations GAO made in fiscal year 1989. For example, IRS (1) made organizational changes intended to provide executive direction over information and financial management activities, (2) developed critical success factors for use in measuring performance and assessing accomplishments, (3) took steps to use its collection resources more efficiently and better protect the collection of tax revenues on completed criminal prosecution cases, (4) improved its methodology for studying the effects of the refund offset program on compliance, and (5) said it would start matching independent contractors' information returns with their tax returns by January 1991 and would help state and local governments better understand their requirements for reporting payments made to independent contractors.

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GAO does its work on tax policy and administration matters pursuant to 31 U.S.C. 713, which authorizes the Comptroller General to audit IRS and the Bureau of Alcohol, Tobacco, and Firearms. GAO Order 0135.1, as

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amended, prescribes the procedures and requirements that must be followed in protecting the confidentiality of tax returns and return information made available to GAO when doing tax-related work. This order is available upon request.

Copies of this report are being sent to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Commissioner of Internal Revenue. Copies will also be sent to interested congressional committees and to others upon request.

Major contributors to this report are listed in appendix VIII. If you or your colleagues would like to discuss any of the matters in the report, please call me on 275-6407 or Paul Posner, Associate Director, on 272-7904.

*Jennie S. Stathis*

Jennie S. Stathis  
Director, Tax Policy and  
Administration Issues





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**Abbreviations**

ACS	Automated Collection System
ADP	automated data processing
AES	Automated Examination System
IRS	Internal Revenue Service
SSA	Social Security Administration
VA	Veterans Administration

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## ADP and Information Technology

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### Progress in Installing IRS' Communications Replacement System

(GAO/IMTEC-89-14, 02/22/89)

At the request of the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO reviewed the status of IRS' installation of a new \$156 million Communications Replacement System. The system consists of computers and software that enable IRS personnel to access mainframe computers through computer terminals in order to process taxpayer inquiries and correct tax returns.

GAO found that (1) tests of the new system at IRS' Martinsburg, West Virginia, Computing Center identified about 900 software problems—most of which had been corrected by January 1989; (2) IRS had not formally accepted the system as of January 1989 because the contractor had not corrected all of the problems and had not delivered acceptable documentation describing how the system's software worked and how it could be used; (3) IRS decided, in November 1987, to install the new system at its 10 service centers despite the remaining problems, because it believed those problems would not adversely affect the system's ability to process taxpayer inquiries or correct tax returns—a decision that GAO considered reasonable; and (4) the system had been installed at all 10 centers by December 1988.

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### Related GAO Product(s)

GAO/T-IMTEC-89-2, 3/16/89; GAO/IMTEC-88-31, 3/31/88; GAO/T-IMTEC-87-1, 2/6/87; and GAO/IMTEC-87-3BR, 10/14/86

## **IRS Needs to Assess Design Alternatives for Its Electronic Filing System**

(GAO/IMTEC-89-33, 05/05/89)

In a report to the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' development of an electronic filing system, which is intended to streamline the tax processing system by using computers instead of the traditional paper forms for filing individual tax returns. The report focused on (1) problems the electronic filing system encountered during the 1988 and 1989 filing seasons and (2) IRS' approach for expanding electronic filing nationwide in 1990.

GAO found that (1) IRS had spent about \$13 million through fiscal year 1988 developing an electronic filing system; (2) although the system processed about 583,000 returns during the 1988 filing season, it experienced problems when a major software component failed to operate as intended; (3) IRS experienced similar problems during the 1989 filing seasons because replacement software was not ready on time; and (4) IRS' failure to clearly define system performance requirements or allow adequate time to decide whether contract deliverables were acceptable contributed to the software problems and resulted in IRS paying for defective software.

GAO noted that IRS intended to expand the availability of electronic filing nationwide in 1990 by enhancing the current system rather than replacing it. GAO expressed its concern with that approach because (1) the current system was originally developed only as an interim measure until a nationwide system could be fielded and (2) IRS had not yet demonstrated that this approach was best for achieving the agency's ultimate goals for electronic filing.

### **Recommendation(s)**

The Commissioner of Internal Revenue should validate the design approach for the nationwide electronic filing system before selecting and funding a system. At a minimum, IRS should (1) clearly define system requirements for nationwide implementation, including determining how it will minimize the burgeoning, paper-intensive nature of the current system and accommodate the processing of tax due returns and (2) identify and analyze the costs and benefits of various alternatives for meeting the requirements for a nationwide system.

The Commissioner of Internal Revenue should ensure better management in contracting for automated data processing (ADP) support services by (1) revising IRS procedures to require project offices to get

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technical assistance in writing and negotiating contracts for major ADP systems and (2) allowing enough time to thoroughly test deliverables, thereby ensuring product quality.

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**Action(s) Taken and/or  
Pending**

IRS agreed with the recommendations and has completed or is in the process of completing their implementation. For example, IRS said that electronic filing will be operational nationwide by the 1990 filing season and system requirements have been clearly defined. IRS also said that it was determining how to reduce the paper-intensive aspect of the current system and that the costs and benefits of various alternatives for meeting requirements for a nationwide electronic filing system have been established. With regard to our recommendation about ensuring better management in contracting for ADP support services, IRS has developed a new project planning process which is currently being used in its ADP modernization projects.

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**Related GAO Product(s)**

GAO/T-IMTEC-89-2, 3/16/89 and GAO/IMTEC-88-40, 7/13/88



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**Testimony on IRS'  
Progress in  
Implementing Its  
Electronic Filing and  
Communications  
Replacement Systems**

(GAO/T-IMTEC-89-2, 03/16/89)

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' (1) development of an electronic filing system for individual tax returns and (2) progress in installing new communications processors.

With respect to electronic filing, GAO noted that IRS (1) abandoned its original plans for a nationwide system in November 1986 because its strategy for acquiring the necessary computers had been disapproved by the Department of the Treasury; (2) implemented an interim system for use in 16 of its 63 districts during the 1988 filing season; (3) expanded electronic filing from 16 to 48 districts in 1989 even though the interim system used in 1988 was not completely successful and a modified version of that system was not ready for use; (4) proposed to expand and modify the interim system for nationwide implementation, although it had not demonstrated the system's ability to meet its long-range needs; and (5) spent about \$13 million through 1988 and planned to spend another \$163 million on system development and operations through 1999.

With respect to the Communications Replacement System, GAO noted that IRS (1) awarded a contract to replace its existing data communication processing system and obsolete computer terminals; (2) experienced several project delays due to contract award protests and redirection of contract efforts; (3) installed, in November 1987, its new Communications Replacement System, which is now operational at all 10 service centers and is working reasonably well; and (4) is withholding contractor payments until the contractor provides acceptable systems documentation and corrects some software problems that do not affect returns processing.

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**Related GAO Product(s)**

GAO/IMTEC-89-33, 5/5/89; GAO/IMTEC-89-14, 2/22/89; GAO/IMTEC-88-40, 7/13/88; GAO/IMTEC-88-31, 3/31/88; GAO/T-IMTEC-87-1, 2/6/87; and GAO/IMTEC-87-3BR, 10/14/86

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## **Analysis of Proposal for Direct Deposit of Income Tax Refunds**

**(GAO/IMTEC-89-34, 02/24/89)**

In a report to Senator Daniel Inouye, GAO commented on a proposal to electronically transfer federal income tax refunds directly into taxpayers' bank accounts. IRS already offers electronic refunds on returns filed electronically. The proposal would extend that service to returns filed on paper and would require IRS to notify the taxpayer by mail before making the electronic transfer.

While noting that there was no disagreement on the technical feasibility of offering income tax refunds by direct deposit to taxpayers who file paper returns, GAO cited the following concerns raised by IRS: (1) taxpayers and IRS staff could err in transcribing the bank routing and transit number and the taxpayer's bank account number if the information were provided to IRS using paper returns; (2) the proposal would be costly to implement for paper returns; (3) the proposed provision to notify the taxpayer by mail before making the electronic payment was unneeded and costly and could delay refund receipt; and (4) little time would be saved in issuing refunds by electronic transfers, rather than by checks, since a direct deposit refund would arrive only 1 to 4 days before a check.

GAO noted that (1) officials of Treasury's Financial Management Service and IRS agreed that the direct deposit option should not be offered to taxpayers filing paper returns until a way was found to reduce the error potential and the cost and (2) IRS' Research Division was working to develop a direct deposit proposal that would ensure data accuracy and be cost effective.

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## IRS' Automated Examination System—Troubled Past, Uncertain Future

(GAO/IMTEC-89-54, 06/22/89)

In response to a request from the Subcommittee on Oversight, House Committee on Ways and Means, GAO reviewed IRS' Automated Examination System (AES), which is intended to automate the examination of income tax returns. GAO focused on (1) IRS' progress in developing and implementing AES and (2) AES' compatibility with IRS' Tax System Modernization effort, which is intended to streamline tax processing through increased automation.

GAO found that IRS (1) projected a total cost of \$77 million for AES development and implementation when it established the project in 1982; (2) significantly expanded the project in 1984 and 1985, projecting completion by 1989 at a total cost of \$1 billion; (3) spent about \$187 million on AES from its inception through fiscal year 1988; (4) currently estimates project completion by 1995 at a total cost of \$1.8 billion; (5) currently projects AES benefits at \$16.2 billion over its 9-year life, down from a contractor estimate of \$42.7 billion in 1987; (6) has not convincingly demonstrated or verified any dollar benefits from the single currently operational AES component; (7) cited software development problems as the primary cause of AES cost overruns and schedule slippages; (8) decided to develop AES independently from its Tax System Modernization effort, so as not to postpone implementation of AES, and then incorporate AES into the modernization effort later—a decision that may require costly system modifications; and (9) had its 1990 AES budget request reduced by the Office of Management and Budget from \$110 million for continued development and operations and maintenance to \$19.5 million for operations and maintenance only.

IRS officials told GAO that the AES project would not be abolished because they believe automating the examination function will provide major benefits. Accordingly, IRS planned to restructure the project and seek increased funding in the fiscal year 1991 budget.

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## Recommendation(s)

Before additional investments are made in AES, the Commissioner of Internal Revenue should establish a sound and consistent methodology for estimating its benefits. To validate this methodology and measure the success of further development efforts, estimated benefits should be compared with actual benefits achieved as components of the system are deployed, and the Commissioner should make this comparison available to Congress as part of the agency's annual budget submission.

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In view of the unresolved questions concerning AES integration with Tax System Modernization, the Commissioner should develop a strategy to enable AES to function effectively with other components of the modernized system. In particular, IRS should determine how AES standards for data structures can be made consistent with the standards of other systems within the modernization effort.

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**Action(s) Taken and/or  
Pending**

IRS generally agreed with the recommendations and is in the process of revising and enhancing AES. Specifically, IRS agreed that each future segment of the system should be closely monitored and said that a Statement of Work would soon be released to an independent contractor, which would establish a method of evaluating productivity and tracking actual usage and impact. IRS said also that it expects to develop a strategy for integrating AES within its modernization effort early in fiscal year 1990.

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**Related GAO Product(s)**

GAO/T-IMTEC-89-4, 4/4/89

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**Testimony on the  
Budgetary  
Implications of IRS'  
Tax System  
Modernization and  
Automated  
Examination System  
Efforts**

(GAO/T-IMTEC-89-4, 04/04/89)

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' fiscal year 1990 budget for automation initiatives. GAO noted that (1) IRS' budget request of \$933 million for automated data processing focused on two critical efforts—maintaining existing computer systems and pursuing its long-range automation plan, known as Tax System Modernization, and (2) total estimated costs for the modernization effort had been understated in past years and were difficult to track because projects were renamed, consolidated, split, and not always clearly identified in budget documents.

GAO also discussed AES, which is intended to automate the examination of tax returns. GAO said that (1) AES' estimated costs had risen from \$1 billion to \$1.8 billion and the system's scheduled completion date had slipped from 1989 to 1995 due to software development problems; (2) IRS had developed AES without adequate planning for its integration into the modernization system and had not addressed how it would make AES data structures consistent with other data structures; and (3) the Office of Management and Budget had reduced the AES budget request by 82 percent because it lacked clear management direction and tangible benefits.

GAO expressed the belief that IRS should (1) clearly and consistently identify all projects that comprise the modernization program in its yearly budget requests and (2) resolve AES problems, demonstrate its benefits, and plan for its integration into system modernization before making further investments.

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**Related GAO Product(s)**

GAO/IMTEC-89-54, 6/22/89 and GAO/T-GGD-89-16, 4/4/89

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## Compliance

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### IRS' Combined Annual Wage Reporting Reconciliation Program

(GAO/GGD-89-21, 12/14/88)

In a report to the Joint Committee on Taxation, GAO provided information on the Combined Annual Wage Reporting Reconciliation Program. The primary purpose of this program is to ensure that employers submit correct wage and tax withholding information to both IRS and the Social Security Administration (SSA) so that (1) employees' social security accounts can be properly credited and (2) proper income and employment tax withholding can be collected from employers.

GAO reported that (1) under an agreement between IRS and SSA, IRS assumed responsibility for matching employers' annual earnings information reported to SSA with the comparable quarterly earnings information and income tax withholding reports submitted to IRS, (2) the number of discrepancies with potential tax implications that IRS annually identified totaled about 500,000 between 1981 and 1984 and then increased to 791,000 in 1986, (3) IRS resolved an average of 54 percent of the discrepancies between 1981 and 1986, and (4) the discrepancies accounted for about 0.1 percent of the taxes withheld from 1981 to 1986.

GAO found that, from 1981 to 1984, IRS (1) assessed employers additional taxes, interest, and penalties of \$2.7 billion, but abated almost \$1.4 billion of those assessments and (2) collected almost \$500 million leaving an uncollected amount of \$800 million at the time of GAO's review. GAO said that IRS planned to double its staff assigned to Reconciliation Program cases in fiscal year 1989, which IRS expected would allow it to resolve almost all of the cases with tax implications and help it identify patterns of employers who are responsible for the discrepancies.

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### Related GAO Product(s)

GAO/T-HRD-88-29, 8/9/88 and GAO/HRD-87-52, 9/18/87

## Labor and IRS Enforcement of the Employee Retirement Income Security Act

(GAO/HRD-89-32, 01/23/89)

In response to a request from the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO reviewed efforts by the Department of Labor and IRS to enforce the Employee Retirement Income Security Act's pension plan provisions. Labor is primarily responsible for enforcing the act's fiduciary provisions and for ensuring that pension plan information is reported and disclosed to plan participants and other interested parties. IRS is primarily responsible for administering the act's participation, vesting, and funding standards and for determining whether pension plans qualify for favorable tax treatment.

In discussing IRS' role, GAO said that (1) the number of pension plans that IRS examined totaled about 20,000 in fiscal year 1985, decreased to about 14,500 in 1986, further decreased to about 5,300 in 1987, then increased to about 12,000 during the first 9 months of fiscal year 1988; (2) IRS cited 20.5 percent of the plans for violations in fiscal year 1985, 28.9 percent in 1986, 32 percent in 1987, and 22.3 percent during the first 9 months of fiscal year 1988; (3) the number of violations IRS identified decreased from 18,037 in fiscal year 1985 to 14,742 in 1986, and 6,409 in 1987; (4) the violations IRS cited most often during fiscal years 1986 and 1987 involved prohibited transactions, pension plan contributions that were not sufficient to satisfy minimum funding requirements, and failures to include eligible persons in a plan or meet minimum coverage requirements; (5) IRS assessed taxes and penalties of \$7.9 million in fiscal year 1985, \$10.2 million in 1986, \$12.5 million in 1987, and \$3.4 million in the first 9 months of 1988; (6) revocations of plans' tax-qualified status increased from 78 in fiscal year 1985 to 167 in 1986, then dropped to 45 in 1987; and (7) the average number of hours spent on a pension plan examination declined from about 15 in fiscal years 1986 and 1987 to about 13 in 1988.

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## Improving IRS' Business Nonfiler Program

(GAO/GGD-89-39, 03/08/89)

On May 24, 1988, GAO issued a report entitled Tax Policy and Administration: IRS Could Reduce the Number of Unproductive Business Nonfiler Investigations (GAO/GGD-88-77) as a result of analyzing data from four states. Subsequently, GAO received additional information from one of the four states—California—and IRS. In its March 1989 report, GAO discussed its analysis of that data.

California provided state employment tax information on 100 businesses that IRS had identified as potential nonfilers of employment tax returns. IRS had closed these cases without obtaining returns after the businesses claimed that they had not paid wages during the periods in question. GAO's analysis of California's data disclosed that (1) 21 of the businesses were liable for 31 delinquent federal employment tax returns because they paid wages during periods for which they reported paying none and (2) IRS could use state employment tax information not only to identify erroneous taxpayer statements but also to more expeditiously close investigations involving businesses that owed no taxes.

After reviewing additional information received from IRS, GAO noted that IRS (1) continued to mail employment tax publications to nonfilers with invalid addresses because a computer code that automatically generated mailing lists was still on the master file and (2) was unable to estimate the cost of the erroneous mailing because it did not track the numbers of publications forwarded to invalid addresses.

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### Recommendation(s)

The Assistant Commissioner for Collections should

- direct IRS collection staffs in the California district offices to use California state employment tax information in business nonfiler investigations and explore similar opportunities for using other states' tax information in the business nonfiler program and
- direct appropriate collection staff to work with computer services staff to correct the computer coding problem so that employment tax publications are not mailed to invalid addresses.

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### Action(s) Taken and/or Pending

IRS is examining how to obtain California State employment tax data on a regular and, if possible, automated basis and plans to determine what specific changes are needed to correct the publication mailing problem.



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IRS is also considering using the state of Virginia's State Taxation Accounting Reporting System to better identify unproductive cases.

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<b>Related GAO Product(s)</b>	<b>GAO/GGD-88-77, 5/24/88</b>
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## Reducing Delays in the Pursuit of Tax Revenue on Closed Criminal Cases

(GAO/GGD-89-41, 03/16/89)

In response to a request from the Joint Committee on Taxation, GAO evaluated IRS' General Enforcement Program, focusing on (1) the amount of civil tax assessed and collected and (2) IRS' process for referring completed cases for civil action. It is under this program that IRS investigates criminal tax violations other than those involving income derived from illegal sources, such as drug trafficking.

GAO reviewed selected General Enforcement Program cases completed in fiscal year 1984 and found that IRS (1) had assessed about \$204 million in penalties on 2,470 criminal cases and was still auditing another 408 cases; (2) had collected \$89 million of the \$204 million assessed, was actively attempting to collect another \$58 million, and had determined that \$57 million was uncollectible; (3) had not timely referred cases for civil action once criminal action had been completed; and (4) lacked internal controls to track cases that could be referred for civil action.

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### Recommendation(s)

To better protect the collection of tax revenues on completed criminal prosecution cases:

- The Commissioner of Internal Revenue should establish appropriate internal control mechanisms in the Criminal Investigation Division to better ensure prompt notification to the Office of Chief Counsel about actions taken on criminal prosecution cases and about delayed authorizations of civil action on such cases.
- The Chief Counsel should establish controls to better ensure timely authorization of civil action on completed criminal prosecution cases.

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### Action(s) Taken and/or Pending

A criminal investigation task force recommended that the responsible special agent have letters signed by the U.S. Attorney on the day criminal action is completed to authorize civil action. IRS' Criminal Investigation Division is drafting form letters for this purpose and adding fields to its management information system to track compliance with this new requirement.

The Office of Chief Counsel has established new criteria and additional guidance for its attorneys. The attorneys are required to authorize civil action within 5 days of the completion of all criminal action. Counsel has also expanded its automatic closing procedures to these criminal cases to ensure their timely closure.

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<b>Related GAO Product(s)</b>	<b>GAO/GGD-88-61, 4/25/88</b>
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## Status of IRS' Studies of the Refund Offset Program

(GAO/GGD-89-60, 04/25/89)

Under the Refund Offset Program, IRS offsets federal tax refunds due taxpayers who are delinquent in paying such debts as child and spousal support payments or federal education loans. IRS has made several studies to assess the effect, if any, of refund offsets on taxpayers' compliance with the tax laws. In a report to the Chairmen of the Senate Committee on Finance and the House Committee on Ways and Means, GAO discussed IRS' methodology for measuring that effect. GAO focused on (1) IRS' improvements to its study methodology and (2) ways to make future studies' results more precise.

GAO found that IRS had improved its studies of the effects of offsetting refunds on taxpayer compliance by (1) incorporating previous filing behavior into its analyses for use in establishing patterns to compare with post-offset filing patterns and (2) improving the quality of its study data and its documentation of study programming requirements. However, some methodological limitations remained. Although IRS matched its offset and control groups on some tax characteristics, there was a risk of bias in its findings because it did not account for other relevant preexisting differences such as prior tax-delinquent behavior and non-tax characteristics (e.g., age and geographic location). IRS could further improve its studies by using updated information to measure the level of IRS enforcement action required to make taxpayers compliant and to assess whether noncompliance was temporary or permanent.

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## Recommendation(s)

To improve future studies of the effect of the Refund Offset Program on compliance with tax laws, IRS should make the offset and control groups as comparable as possible. IRS' studies should statistically control for prior tax-delinquent behavior and nontax characteristics, such as age and geographic location. In addition, IRS should use the most current taxpayer information when comparing the offset and control groups' filing behavior over time. This should result in a better understanding of the magnitude of any noncompliance problem, enable IRS to measure the level of enforcement actions required to make taxpayers compliant, and provide a better basis to analyze the temporary versus permanent nature of compliance.

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## Action(s) Taken and/or Pending

IRS agreed that it should make its offset and control groups as comparable as possible. For its April 1989 report on the effects of nontax refund offsets on taxpayer compliance, IRS excluded individuals from its

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study groups who had tax-related offsets in tax years 1984-1986. IRS plans further improvements in study group comparability. For example, in future studies, IRS plans to consider nontax characteristics such as age and geographical location when comparing the offset and control group's filing behavior.

IRS did not agree that it should use the most current taxpayer information when comparing the offset and control groups' filing behavior over time. IRS said that its current study approach classifies a nonfiler as any taxpayer not filing by the end of September of the filing year. IRS believes this to be an appropriate approach to studying the effect of offsets on voluntary compliance, which IRS says is the purpose of the study. Using the most current taxpayer data to identify the level of enforcement action needed to make noncompliant taxpayers file returns, as we suggested, was not the purpose of its study, according to IRS.

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<b>Related GAO Product(s)</b>	GAO/GGD-88-117, 9/1/88 and GAO/GGD-87-39BR, 2/9/87
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## State and Local Compliance With IRS' Information Reporting Requirements

(GAO/GGD-89-63, 05/04/89)

In response to a request from the Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO determined whether state and local governments were complying with IRS requirements for filing information returns to report payments made to independent contractors.

GAO found that (1) state agencies and local governments in GAO's sample only reported about 10 percent of the payments that they should have during 1985 and 1986; (2) most state and local governments' policies and procedures were not in full compliance with IRS requirements, primarily because the governments did not fully understand the requirements; (3) although the governments usually reported payments for professional services such as those provided by attorneys and consultants, they did not report payments for such things as construction, auto repairs, and janitorial services because they erroneously believed that payments for such services fell outside the reporting requirements; and (4) IRS examined businesses' income tax returns but did not monitor state and local governments' compliance with the reporting requirements.

GAO said that IRS had contracted with the National Association of State Auditors, Comptrollers, and Treasurers in 1988 to review information return procedures and compliance levels in six states. As of February 21, 1989, the Association had finished reviews in three states. The Association's Executive Director said that those reviews showed that (1) state governments need to better understand their responsibilities and (2) compliance with those responsibilities has been hampered by states' accounting systems that were not tailored to information reporting.

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### Recommendation(s)

The Commissioner of Internal Revenue should

- establish an IRS focal point to provide assistance to those state and local government officials needing further clarification or elaboration on their reporting requirements;
- encourage state and local audit agencies to routinely check the agencies they audit for information returns compliance; and
- use the National Association of State Auditors, Comptrollers, and Treasurers' study of six states in developing an IRS program for monitoring and enforcing state and local governments' information returns compliance.

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**Action(s) Taken and/or  
Pending**

IRS said that it plans to (1) establish a focal point in the district offices where state and local offices can get help in understanding their reporting requirements; (2) maintain a dialogue with the state offices that are responsible for information return compliance; (3) selectively examine certain states to assess and improve compliance; and (4) provide all states with the results of the National Association of State Auditors, Comptrollers, and Treasurers' study and encourage them to do compliance reviews.

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**Related GAO Product(s)**

GAO/GGD-89-107, 9/25/89; GAO/GGD-89-110, 9/8/89; and GAO/T-GGD-89-21, 5/16/89

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## Missing Independent Contractors' Information Returns Not Always Detected

(GAO/GGD-89-110, 09/08/89)

In response to a request from the Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operation, GAO reviewed whether IRS' examinations effectively identified businesses that failed to file information returns for payments made to independent contractors.

GAO found that (1) IRS examinations of business tax returns did not effectively identify businesses that failed to file required information returns on payments to contractors; (2) revenue agents did not identify an estimated 1,261 information returns that 467 businesses should have filed, involving about \$6.2 million in payments; (3) managers said that they did not stress the importance of these compliance checks because other issues such as overstated deductions and unreported income took higher priority; (4) because managers did not enforce workpaper standards requiring agents to document the scope and depth of their work, they did not know the extent to which checks were made; (5) IRS procedures for doing compliance checks were vague; and (6) data that could help revenue agents check compliance were not being used.

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### Recommendation(s)

To improve IRS compliance checks of information return reporting requirements, the Commissioner of Internal Revenue should

- require that field managers and quality reviewers stress the importance of doing compliance checks, enforce workpaper standards, and assess the effectiveness of the checks;
- establish minimum requirements for revenue agents to follow in doing compliance checks; and
- require that data summarizing businesses' information return filings be made available to, and be used by, revenue agents when doing compliance checks.

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### Action(s) Taken and/or Pending

IRS plans to establish requirements for compliance checks and is taking corrective actions to ensure that data on business' information return filings are being used.

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### Related GAO Product(s)

GAO/GGD-89-107, 9/25/89; GAO/T-GGD-89-21, 5/16/89; and GAO/GGD-89-63, 5/4/89



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## **Information Returns Can Be Used to Identify Employers Who Misclassify Workers**

**(GAO/GGD-89-107, 9/25/89)**

In response to a request from the Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO assessed whether matching independent contractors' information returns with their tax returns would provide IRS with a systematic method for identifying employers who misclassify employees as independent contractors.

From information returns, GAO identified about 191,000 independent contractors who had received all of their income from one of about 32,000 employers. IRS' revenue officers (1) interviewed a sample of 408 of those employers and determined that 157 had misclassified their employees as independent contractors; (2) completed detailed examinations of 95 of those 157 employers and found that 92 had misclassified 17,347 employees; and (3) recommended, for those 92 employers, taxes and penalties of \$16.7 million in 1986 and 1987.

GAO also noted that (1) IRS would not have to create a new matching process to identify misclassifications because it already matched information returns and income tax returns to identify unreported income and (2) although IRS could use information returns to better identify misclassified employees, section 530 of the Revenue Act of 1978 prohibits IRS from assessing back taxes that should have been withheld and paid and restricts IRS' authority to require certain employers to reclassify workers, even for future years.

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### **Recommendation(s) to IRS**

To more systematically identify employers who are misclassifying employees as independent contractors and to better target audit resources for doing employment tax examinations, IRS should match independent contractors' information returns with their tax returns.

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### **Recommendation(s) to Congress**

In view of the equity issues and tax revenues involved, Congress may want to consider repealing the restriction against requiring employers to prospectively reclassify employees who have been misclassified as independent contractors.

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**Action(s) Taken and/or  
Pending**

IRS said it plans to start matching independent contractors' information returns with their tax returns by January 1991. No congressional action with respect to section 530 had been taken or was planned as of December 31, 1989.

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**Related GAO Product(s)**

GAO/GGD-89-110, 9/8/89; GAO/T-GGD-89-21, 5/16/89; and GAO/GGD-89-63, 5/4/89

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## **Testimony on the Information Return Requirements for Independent Contractors**

(GAO/T-GGD-89-21, 05/16/89)

In testimony before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO discussed work it was doing for the Subcommittee on information returns used to report payments made to independent contractors. GAO assessed (1) IRS' efforts to ensure that employers submit the required information returns and (2) the merits of using information returns to detect employers who misclassify employees as independent contractors.

GAO noted that (1) federal, state, and local governments, as well as private sector businesses, were not fully complying with IRS' information return reporting requirements, partly because IRS had done little to promote compliance; (2) IRS had not made a concerted effort to help government officials understand information reporting responsibilities and had put a low priority on identifying businesses who did not submit required information returns; (3) IRS did not have a systematic approach for identifying employers who misclassify workers; and (4) IRS could use information returns to better target its enforcement resources on those employers most likely to misclassify. These matters are more fully discussed in the summaries of three reports GAO issued on the results of its work. (See pp. 29, 31, and 32.)

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## **Related GAO Product(s)**

GAO/GGD-89-107, 9/25/89; GAO/GGD-89-110, 9/8/89; and GAO/GGD-89-63, 5/4/89

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**Periodic Evaluation  
Needed If IRS Uses  
Levies to Collect  
Deferred Accounts**

(GAO/GGD-89-34, 02/14/89)

In a report to the Joint Committee on Taxation, GAO discussed IRS' planned use of levies to collect taxes on deferred delinquent accounts. Deferred accounts are those that IRS considers too small to justify going through the complete collection process.

GAO found that (1) in 1988, IRS developed a plan for taking a more active approach to resolving deferred individual taxpayer accounts that would involve annually levying taxpayer assets; (2) although IRS' past studies and GAO's analysis suggested that using levies to collect deferred accounts had merit, there was insufficient information available to adequately evaluate the cost-effectiveness of such a program or whether it would adversely affect other operations; (3) IRS did not consider business deferred accounts in its plans because no national program existed for identifying business assets that could be levied; and (4) IRS decided, before proceeding with nationwide implementation of the deferred account levy program, to further evaluate such things as the program's costs and benefits and its impact on computer capacity and to consider both individual and business accounts in that evaluation.

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**Recommendation(s)**

If a nationwide levy program is implemented for deferred accounts, the Commissioner of Internal Revenue should establish procedures for periodically evaluating the program's effectiveness.

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**Action(s) Taken and/or  
Pending**

After further study and analysis, IRS decided not to implement a nationwide levy program to collect deferred delinquent accounts. In reaching its decision, IRS concluded that such a program would not be cost effective.

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## **Statistics on IRS' Use of Levies to Collect Delinquent Taxes**

(GAO/GGD-89-97FS, 07/17/89)

In a fact sheet prepared for the Joint Committee on Taxation, GAO provided information on the results of IRS' use of levies to collect delinquent taxes through its Automated Collection System (ACS).

GAO said that (1) IRS used levies to attempt collection from about one-half of the delinquent taxpayers whose accounts it had sent to ACS during 1986; (2) IRS averaged about two levies per taxpayer, of which about one-half were productive; (3) tax collections totaled about \$696 million between the time IRS sent the cases to ACS in 1986 until mid-1988; and (4) business levies produced slightly more per taxpayer than individual levies.

## **IRS Can Improve the Process for Collecting 100-Percent Penalties**

(GAO/GGD-89-94, 08/21/89)

If IRS cannot collect income and Social Security taxes from a business that has withheld them from employees' paychecks, it may assess responsible persons, such as corporate officers, a penalty in the same amount as the withheld taxes. In response to a request from the Joint Committee on Taxation, GAO reviewed IRS' collection of these assessments, referred to as 100-percent penalty assessments, to determine whether IRS could collect them more efficiently and effectively.

GAO analyzed a sample of 200 penalty case files selected at random from a universe of 793 files closed during the 4 months ended October 31, 1987, at four IRS district offices. GAO reported that (1) 100-percent penalty cases, unlike most other delinquencies, were sent directly to revenue officers in IRS' 63 district offices for collection, thus bypassing IRS' Automated Collection System (ACS); (2) as such, those cases did not compete on an equal basis with other delinquencies referred by ACS for district collection resources, and the efficiencies associated with ACS' computerized recordkeeping, telephone technology, and improved management control went unrealized; and (3) IRS spent an average of \$247 to close 100-percent penalty cases via revenue officers, compared to \$57 on cases processed through ACS.

Although not required by the Internal Revenue Manual, revenue officers said that they often obtain taxpayers' financial statements to identify levy sources during initial investigations. GAO found that financial information, including levy sources and financial statements, obtained by revenue officers during initial investigations was not readily available for subsequent use by revenue officers trying to collect the delinquencies because (1) investigating officers did not routinely arrange to have levy sources inputted into IRS' computerized levy source file and (2) financial statements obtained by investigating officers were not being routinely included with the delinquency documents provided to the collecting officers.

GAO also found that (1) adequate internal controls were not in place to assure that the correct amount of delinquent tax was collected—a factor that caused revenue officers to over-or under-collect the delinquencies in about 9 percent of the 793 cases in GAO's universe and (2) available information on the status of delinquencies was not adequate to accurately report that portion of the accounts receivable balance applicable to 100-percent penalties.

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**Recommendation(s)**

To ensure that IRS uses collection resources more efficiently, the Commissioner of Internal Revenue should

- establish a milestone for completing as quickly as possible servicewide implementation of procedures for processing 100-percent penalty cases through ACS,
- revise the Internal Revenue Manual to conform to the stated practice of obtaining financial information when responsible parties are identified during initial investigations and it is appropriate to do so,
- establish appropriate controls to ensure that levy sources identified during the 100-percent penalty investigations are documented in IRS' computerized levy source file so that they are readily available during the collection phase, and
- develop a procedure to ensure that financial statements obtained during the investigations are available on ACS' computerized database to facilitate processing of 100-percent penalties through ACS.

To improve accounting and internal controls, the Commissioner of Internal Revenue should establish milestones for (1) completing the development of procedures to systematically provide collection employees with the information needed to accurately determine the status of delinquencies and (2) developing a way to more accurately report the accounts receivable balance as it relates to 100-percent penalties.

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**Action(s) Taken and/or Pending**

IRS generally agreed with the report's recommendations and, in most cases, has initiatives underway that respond to the recommendations or their intent. For example, on the basis of the results of its 100-percent penalty test, IRS has decided to process, on a nationwide basis, 100-percent penalty cases through ACS during fiscal year 1990. Also during that year, IRS plans to complete an analysis of various systems that are available for establishing appropriate controls to ensure that the levy sources obtained during a 100-percent penalty investigation are input to IRS' levy source file.

IRS has developed a procedure that is intended to ensure that financial data secured during 100-percent penalty investigations are also input to the database for ACS use.

IRS is also implementing a proposal for systemic changes which will allow employees to readily determine correct account balances of related 100-percent penalty cases. IRS plans to begin system acceptability testing in May 1990. In addition, IRS is working with Treasury to

ensure that 100-percent penalties are accurately reflected in the accounts receivable balance.

IRS did not agree, however, to revise its instructions to conform to the revenue officers' stated practice of obtaining taxpayer financial information during initial investigations because it (1) did not believe that such data should be obtained during the course of all investigations and (2) said that the Internal Revenue Manual adequately defines those instances in which financial data should be obtained. GAO agrees that it may not be appropriate to collect financial data in all cases but does not agree that the Manual is clear as to when it should be collected.



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## Options for Civil Penalty Reform

(GAO/GGD-89-81, 09/06/89)

In a report to the Chairman of the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Senate Committee on Finance, GAO (1) provided information on concerns voiced by tax administrators, practitioners, and others about various civil tax penalties and (2) analyzed proposals that have been made to respond to those concerns.

The proposals analyzed in the report were those contained in the Improved Penalty Administration and Compliance Tax Act of 1989 (H.R. 2528, 101st Congress) and in a 1989 IRS civil penalty task force report. The penalties discussed included (1) the penalty for failure to file an income tax return; (2) various information return filing penalties; (3) the penalty for failing to timely deposit employment and other taxes; (4) major taxpayer accuracy/conduct penalties, including those for negligence, fraud, and substantial understatement; (5) return preparer accuracy/conduct penalties; and (6) the penalty for promoting abusive tax shelters. For each of those penalties, the report discusses (1) current law, (2) concerns with the current system, (3) the proposals for change, and (4) GAO's analysis of those proposals.

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## Recommendation(s) to Congress

To support the statutory requirement that all taxpayers file a tax return in a timely manner, Congress should establish a time-sensitive failure to file penalty that would be assessed against all delinquent taxpayers whether or not they had a tax liability, unless the failure is due to reasonable cause.

Congress should ensure that any legislation enacted maintains and enhances the value of penalties in deterring noncompliance. Congress should retain an underreporting penalty similar to the existing presumptive negligence penalty that would penalize taxpayers failing to report income disclosed on information returns. The House-passed bill would have eliminated this penalty.

With regard to penalty rates, Congress should consider setting higher rates than the House bill or reducing the threshold of understated tax liability. This would trigger the substantial understatement penalty to at least partly restore the economic value of the penalties that was eroded in recent years due to lower tax rates.

Congress should increase the monetary value of return preparer penalties to improve their economic deterrent value and should use a two-tier penalty, with the first tier consisting of negligence and the second tier consisting of willful understatement or intentional disregard.

To bolster taxpayer confidence in the fairness and equity of the taxpayer accuracy/conduct penalties, Congress should (1) eliminate stacking of the accuracy/conduct penalties (i.e., assessing more than one penalty for the same act); (2) target the application of the negligence penalty; (3) establish reasonable cause as the abatement/waiver criterion, except for fraud; and (4) statutorily define substantial authority.

Because of the nature of noncompliance associated with tax shelters, Congress should not establish a statute of limitations as recommended by IRS' task force.

To simplify administration, all types of information returns should be treated consistently. Within that context, (1) all caps on the amount of the penalty should be eliminated, (2) there should be a single abatement criterion, (3) magnetic media filing thresholds should be set administratively, and (4) only returns exceeding thresholds should be penalized.

If the penalties for filing late or incorrect information returns are made time-sensitive, as proposed in the House bill and recommended by IRS, IRS should administratively set the penalty dates to allow for potential future changes in underreporter program processing time frames. Further, to promote voluntary correction of returns, penalties should not be assessed against payers who voluntarily correct their returns.

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**Action(s) Taken and/or  
Pending**

The Omnibus Budget Reconciliation Act of 1989, (P.L. 101-239, Dec. 19, 1989) addressed, among other things, the civil penalty reform issue. While not adopting all of GAO's positions on penalty reform, many of GAO's recommendations were included in the act, such as uniform treatment of information returns, elimination of stacking in the accuracy/conduct penalties, targeting of the negligence penalty, and increased preparer penalties.

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**Related GAO Product(s)**

GAO/T-GGD-88-55, 9/28/88; GAO/GGD-88-69, 7/25/88; and GAO/T-GGD-88-24, 3/31/88

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## Excise Taxes and Other Revenue Potential

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### Transition Series: Revenue Options

(GAO/OCG-89-3TR, 11/88)

In this report, one of a series addressing major policy issues facing Congress and the Administration, GAO discussed certain frequently proposed options for raising revenue to reduce the budget deficit. The options discussed included (1) raising income tax rates, (2) broadening the income tax base, (3) enacting a new consumption tax, (4) increasing revenue from federal excise taxes, (5) increasing IRS' enforcement of tax laws, and (6) increasing nontax revenue sources.

In discussing those options, GAO said that (1) it will be extremely difficult, based on past experience, to bring down the deficit without some revenue increases and (2) a combination of revenue options could emerge because each option alone has some drawbacks. For example (1) many Members of Congress believe that they have a tacit agreement with the public, through the Tax Reform Act of 1986, not to raise rates; (2) a consumption tax could be regressive, with low-income persons paying a higher percentage of their income in this tax than those earning higher incomes; and (3) hiring and training additional enforcement staff could take several years.

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**Economic,  
Administrative, and  
Taxpayer Compliance  
Aspects of a Gross  
Income Tax**

(GAO/GGD-89-36, 02/16/89)

In response to a request from Senator Charles Grassley and Congressman Bill Archer, GAO reviewed Treasury and Congressional Research Service literature and studies to (1) identify the general economic effects of a gross income tax and (2) compare certain administrative and taxpayer compliance aspects of the tax with the current tax system. A gross income tax, as opposed to a net income tax, would tax (1) the total receipts of a firm with few or no deductions for the costs of doing business and (2) the total income of an individual with no deductions of any kind.

GAO found that a gross income tax would (1) reduce competition by providing an incentive for producers and suppliers to merge, (2) tax firms that earned little net income or suffered a loss, (3) be a disincentive to investment by raising the effective marginal tax rate on capital, and (4) shift the distribution of the tax burden to lower-income people. GAO also noted that (1) proponents believed that a gross income tax would reduce administrative and taxpayer compliance costs if it replaced corporate and personal income taxes and (2) IRS believed that a gross income tax would neither simplify the tax system nor reduce its administrative costs, and the transition to such a system would place an overwhelming burden on IRS.

GAO expressed the belief that a gross income tax system would not be preferable to the current system, even if it were less costly, because of its potential for greater economic distortion.

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## Revenue Potential of Restoring Excise Taxes to Past Levels

(GAO/GGD-89-52, 05/09/89)

In a report to the Joint Committee on Taxation, GAO discussed (1) alternatives for increasing revenues from excise taxes imposed on alcoholic beverages, tobacco, gas-guzzling automobiles, firearms, and wagering occupations and (2) associated policy and administrative issues.

GAO reported that (1) the excise taxes it reviewed had not been updated to reflect inflation; (2) the Joint Committee estimated that if those taxes had been updated to keep pace with inflation, they would have generated additional revenues of \$2 to \$13 billion in 1989 and \$12 to \$75 billion over the 5 years from 1989 to 1993; and (3) to ensure that the real dollar value of excise tax revenues does not erode over time without periodic congressional intervention, Congress could index per-unit tax rates to an appropriate measure of price change or convert per-unit taxes to ones that are imposed as a percentage of the price of the product or service.

GAO said that (1) increasing or changing the excise tax rate structure might cause administrative problems and (2) while opponents of excise tax increases argue that such taxes are regressive and decrease consumption, a majority of the public favors increases in certain excise taxes, specifically those involving alcohol and tobacco, since such taxes help reduce the deficit and offset some of the social costs resulting from the consumption of the taxed items.

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## Related GAO Product(s)

GAO/HRD-89-119, 6/30/89

## **Tax-Credit and Subtraction Methods of Calculating a Value- Added Tax**

(GAO/GGD-89-87, 06/20/89)

In a report to the Joint Committee on Taxation, GAO provided information on the two principal methods for calculating a value-added tax—the subtraction method and the tax-credit or invoice method. The subtraction method calculates the tax using information on the total business activity of a firm while the tax-credit method calculates the tax for each transaction. GAO analyzed each method's impact on regressivity and U.S. competitiveness and discussed the compliance and administrative costs associated with each method.

With respect to regressivity, GAO said that (1) a single-rate value-added tax would make low-income households pay a higher percentage of their income in value-added taxes, since they spend a larger part of their income on consumption than higher income households; (2) alternatives to reducing the regressivity of a value-added tax include providing a tax credit for low-income households on their tax returns or imposing multiple value-added tax rates; (3) although providing refundable tax credits would be compatible with either the tax-credit or subtraction method, only the tax-credit method would be compatible with multiple rates; and (4) multiple rates would be complex and would tend to increase administrative and compliance costs.

On the competitiveness issue, GAO noted that (1) although changes in exchange rates may compensate for price increases in domestic goods and services induced by the value-added tax, many countries try to offset potential problems through border tax adjustments that usually involve rebating the tax on exports and imposing the tax on imports; (2) the tax-credit method is well suited for border tax adjustments; and (3) the subtraction method could be used for border tax adjustments but would make verification of exported untaxed goods more difficult.

As for compliance and administrative costs, GAO said that (1) IRS estimated the additional administrative costs associated with a single-rate tax to be about \$700 million annually—less if small firms were exempted from the tax; (2) there were no reliable estimates of the administrative costs associated with a simple subtraction method value-added tax or a multiple-rate tax-credit value-added tax; and (3) there were no comprehensive studies of the compliance costs U.S. taxpayers might experience under either method.

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**Fiscal Year 1989 by Subject Matter**

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<b>Related GAO Product(s)</b>	<b>GAO/GGD-89-125BR, 9/15/89 and GAO/GGD-86-91, 8/20/86</b>
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## **Value-Added Tax Issues for U.S. Tax Policymakers**

**(GAO/GGD-89-125BR, 09/15/89)**

In a briefing report to the Joint Committee on Taxation, GAO provided information on the advantages and disadvantages of the value-added tax, focusing on (1) how the tax would operate, (2) European countries' experiences with value-added tax, and (3) the key issues in deciding whether or not to enact such a tax.

GAO found that (1) a comprehensive 5-percent value-added tax could raise about \$125 billion in revenues annually, while one that exempted food, housing, and medical care would raise about \$72 billion; (2) although a few industrialized countries did not have a value-added tax system, all but the United States had some type of broad-based national consumption tax; (3) 47 countries have introduced a value-added tax over the past 30 years, several countries have considered proposals, and Canada plans to implement a value-added tax in 1991; (4) the European Economic Community required the value-added tax as a condition for membership as a means of decreasing trade and other economic distortions among its members; and (5) most countries use the tax credit method value-added tax, which is calculated separately for each purchase or sale and included in the price at each stage of production or distribution.

GAO said that (1) the value-added tax preserved neutrality between capital and labor, since it created no incentive for businesses to substitute one factor for another; (2) the advantages of the United States adopting a value-added tax would include its potential self-enforcement and lack of bias against savings; and (3) the disadvantages would include regressivity, the impact on international trade, the administrative costs and compliance burden associated with introduction of a consumption tax system at the federal level, and the potential conflicts with state and local tax bases. Some also argue that because the broad-base of a value-added tax allows it to generate large amounts of revenue with small percentage rate increases, there might be a temptation to remove constraints on federal spending increases.

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### **Related GAO Product(s)**

**GAO/GGD-89-87, 6/20/89 and GAO/GGD-86-91, 8/20/86**



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## **Higher Excise Tax Should Significantly Reduce the Number of Smokers**

**(GAO/HRD-89-119, 06/30/89)**

In a report to Congressman Michael Andrews, GAO provided information on the impact of cigarette excise taxes on teenage smoking.

GAO noted that (1) despite the decline in teenage smoking since 1975, smoking among teenagers continues to be widespread; (2) raising the federal excise tax on cigarettes would reduce teenage smoking to the extent that teenage smokers respond to the higher prices; (3) using data from surveys done in the late 1960s and the 1970s, researchers concluded that a 1-percent increase in cigarette prices would lead to a reduction in the rate of teenage smoking from .76 to 1.2 percent; (4) antismoking campaigns and the shift in social norms against smoking since those studies may have left the current pool of teenage smokers more resistant to changes in price; and (5) conversely, the increasing concentration of smokers among low-income people since the studies may have increased teenage price responsiveness.

Given the changes since the latest research and the lack of more definitive evidence, GAO concluded that it would be reasonable to rely on the researchers' smaller (.76 percent) estimate of price responsiveness. Using that estimate, a 21-cent-per-pack increase in the federal excise tax in 1989 would likely lead to a significant reduction of over 500,000 teenage smokers.

## **The Insurance Excise Tax and Competition for U.S. Reinsurance Premiums**

**(GAO/GGD-89-115BR, 09/25/89)**

In response to a request from Congressman Fortney H. (Pete) Stark, GAO examined the effects of the Tax Reform Act of 1986 on competition between U.S. and foreign property and casualty reinsurers in the U.S. market.

GAO found that available data were inconclusive regarding the act's effects on the competitiveness of U.S. reinsurers in the domestic market. Although the foreign share of the U.S. reinsurance market rose since tax reform—from 26.1 percent in 1986 to 32.6 percent in 1987 and a projected 38.6 percent in 1988—the foreign share was also relatively high during the 1960s.

GAO said that several questions should be considered in any deliberations about changing current insurance excise tax policy. These questions include

- What other factors besides the excise tax—such as taxes in foreign countries—influence a reinsurer's relative tax position in the U.S. market?
- Do foreign reinsurers complement U.S. reinsurers and provide coverage that is not normally available in the U.S. market?
- Who bears the burden of the excise tax on reinsurance premiums—U.S. consumers or foreign reinsurers?
- Would an increased excise tax be perceived as a barrier to entry into the U.S. reinsurance market and would it be compatible with recent efforts to liberalize trade?

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## General Management

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### Managing IRS: Actions Needed to Assure Quality Service in the Future

(GAO/GGD-89-1, 10/14/88)

This report was the result of a joint effort between IRS and GAO to find solutions to the major management issues confronting IRS. IRS' most pressing challenges are to (1) better plan and direct its information systems modernization effort, (2) address the deterioration in its ability to attract and retain a quality workforce and leadership cadre, (3) strengthen management of financial systems to resolve significant internal control problems, (4) devise an effective approach to ensure that a "quality first" mindset permeates the agency's internal culture, and (5) ensure more rigorous evaluation of field operations to improve uneven performance and ensure uniform and equitable treatment for all taxpayers.

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### Recommendation(s)

The report contained about 40 recommendations. Key ones were directed at (1) ensuring that IRS' Strategic Business Plan, which was developed to strengthen the link between planning and budgeting, effectively drives IRS' information systems modernization efforts and the annual budget process; (2) improving critical data processing and accounting operations; (3) developing an agencywide performance measurement system to, among other things, gauge progress toward improving quality service to the public; and (4) strengthening internal evaluations of field activities.

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### Action(s) Taken and/or Pending

IRS took several actions before the report was issued. It reorganized its top management structure to improve accountability and strengthen communication. It improved management decisionmaking by setting up a strategic management system and initiated efforts to improve the quality of its services.

Since issuance of the report, IRS has taken several additional steps. Among other things, IRS has (1) made organizational changes intended to provide executive direction over information and financial management activities and (2) established critical success factors for use in developing a performance system and assessing accomplishments against the Strategic Business Plan. IRS has also assigned responsibility for ensuring

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that each recommendation is implemented and has developed a reporting procedure to provide top management with periodic updates on the status of those efforts. GAO is assessing IRS' progress in implementing the recommendations and expects to issue a status report later this year.

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<b>Related GAO Product(s)</b>	GAO/T-GGD-89-6, 2/22/89; GAO/OCG-89-26TR, 11/88; GAO/IMTEC-88-23BR, 4/27/88; and GAO/IMTEC-88-5FS, 11/9/87
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## Testimony on Actions Needed to Assure Quality IRS Service in the Future

(GAO/T-GGD-89-6, 02/22/89)

In testimony before the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Senate Committee on Finance, GAO discussed the critical management challenges IRS faces in ensuring high-quality, tax service—challenges that were discussed in detail in GAO's October 1988 report (see p. 50.)

GAO noted that IRS critically needs to modernize its outdated computer-based tax processing system, but progress in that modernization has been slow due to leadership changes and lack of effective management direction. Although IRS designated one of its deputy commissioners as an information resources manager, he had other significant responsibilities that precluded him from giving the modernization his full-time attention. GAO also noted that (1) weak internal controls over accounting processes and inaccurate processing systems have undermined IRS' ability to satisfy its financial responsibilities; (2) IRS' financial structure has incompatible systems and labor-intensive operations; (3) although IRS has begun a major quality improvement effort, the transition from a production focus to a quality-oriented focus presents a long-term management challenge at the daily operating level; and (4) IRS initiated a strategic management process to help set agencywide goals, establish mission priorities, and measure its progress in meeting its objectives.

GAO said that IRS needs to (1) create a separate deputy commissioner with extensive technical expertise to direct its system modernization, (2) raise the level of executives' technical expertise so they can make informed decisions about the modernization, (3) establish a chief financial officer to direct financial management activities, (4) establish performance measures for all major activities for use in assessing progress in improving workforce quality, and (5) provide adequate oversight over field operations.

Since the testimony, IRS has established the position of Chief Information Officer, one of whose duties will be to oversee system modernization, and has designated the Deputy Commissioner for Planning and Resources as IRS' Chief Financial Officer. IRS is also developing a new business review process, which is to include measurable critical success factors that it can use to evaluate the extent to which an activity supports IRS' Strategic Business Plan.

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**Appendix I**  
**Summaries of Tax-Related Products Issued in**  
**Fiscal Year 1989 by Subject Matter**

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<b>Related GAO Product(s)</b>	<b>GAO/GGD-89-1, 10/14/88</b>
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**Transition Series:**  
**Internal Revenue**  
**Service Issues**

(GAO/OCG-89-26TR, 11/88)

In this report, one of a series addressing issues facing Congress and the administration, GAO summarized tax administration issues that if not addressed could lead to (1) serious problems in processing tax returns, (2) a decline in taxpayer confidence in the tax system, and (3) a significant loss in tax revenues.

GAO said that IRS needs to (1) modernize its inefficient and outdated tax processing system by imparting the necessary sense of urgency to the modernization effort and, with Congress' help, by ensuring that adequate technical expertise and money are available to support the effort; (2) update its accounting and financial systems, the success of which can be enhanced by designating a chief financial officer and by developing a financial management plan to set priorities, fix accountability, and maintain and monitor system operations and improvements; (3) strengthen human resources management by offering more competitive salaries, providing high-quality training, and implementing a quality assurance plan; (4) improve tax collection activities by developing more effective ways to prevent or detect delinquencies; and (5) improve taxpayer compliance by increasing tax audits and developing better information systems for identifying potential noncompliance.

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## Testimony on the Administration's Fiscal Year 1990 Budget Proposals for IRS and the Tax Court

(GAO/T-GGD-89-16, 04/04/89)

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed the administration's fiscal year 1990 budget request for IRS and the Tax Court.

GAO noted that (1) IRS expected to experience a budgetary shortfall in fiscal year 1989 of about \$360 million, partly because of unfunded salaries, employee benefits, and postage fees and partly because of management's decision to undertake initiatives for which funds had not been budgeted; and (2) the administration's fiscal year 1990 budget request for IRS of about \$5.5 billion, although an increase over 1989, would probably not be enough to maintain basic operations, thus raising the prospects for another shortfall. The 1990 budget request appeared insufficient primarily because it did not include funding to cover the substantial costs IRS expected to incur in implementing three new pieces of legislation—The Technical and Miscellaneous Revenue Act of 1988, the Anti-Drug Abuse Act of 1988, and the Medicare Catastrophic Coverage Act.

GAO also noted that (1) the administration's request of \$28.1 million for the Tax Court in fiscal year 1990 was consistent with the Court's level of funding for 1989; (2) the Court had made significant progress in reducing its case inventory; and (3) the Court could experience increased case loads due to various factors, including provisions in the Technical and Miscellaneous Revenue Act of 1988 that expanded the Court's jurisdiction.

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### Related GAO Product(s)

GAO/GGD-89-116, 8/18/89 and GAO/T-IMTEC-89-4, 4/4/89



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**Results of IRS' Mid-  
Fiscal Year 1989  
Financial Review**

(GAO/GGD-89-116, 08/18/89)

In a report to the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' mid-fiscal year 1989 financial review and its actions to offset a budget shortfall of about \$360 million.

GAO found that IRS froze hiring and restricted travel, training, and equipment acquisitions at the beginning of fiscal year 1989 to offset the shortfall, but determined during the mid-year review that those actions would not be sufficient. As a result, IRS further reduced support services, equipment, training, and space alterations, and cut back, various service center programs and post-filing season taxpayer service through furloughs of temporary staff.

GAO reported that, although the full effect of IRS' cutbacks would not be apparent until after fiscal year 1989 (1) taxpayers experienced more difficulty in reaching IRS over the telephone, (2) the manageability of certain service center correspondence inventories decreased, and (3) IRS expected decreased revenues from its document-matching activities. In addition, GAO noted that other potential effects of the cutbacks depended on the extent to which IRS (1) would have to hire inexperienced personnel to compensate for furloughed employees who did not return to IRS and (2) could eventually fund items, such as space alterations, that it had deferred.

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**Related GAO Product(s)**

GAO/T-GGD-89-16, 4/4/89

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## **Testimony on College Students' Perceptions of the Federal Government as an Employer**

**(GAO/T-GGD-89-32, 6/19/89)**

In testimony before the Subcommittee on Federal Services, Post Office and Civil Service, Senate Governmental Affairs Committee, GAO discussed how college students perceive the federal government as an employer. The testimony included information specifically related to IRS' recruiting program.

GAO said that many studies have pointed out the increasing intellectual sophistication and skill levels government work will require and the resulting need for bright, capable employees to enter the federal service. GAO noted, however, that (1) the government is not now in a competitive position to get its fair share of talented graduates and is already having difficulty recruiting and retaining quality personnel; (2) many federal agencies did not actively recruit on college campuses or used less-than-effective recruitment techniques; (3) starting salaries in the private sector were as much as 41 percent higher than those in the federal government; and (4) many students did not know that federal jobs were available; believed that applying for federal employment was confusing, time-consuming, and difficult; and believed that government work could not provide excitement, satisfaction, or adequate pay.

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**IRS' Data on Its  
Investigations of  
Employee Misconduct**

(GAO/GGD-89-13, 11/18/88)

In response to a request from the Chairman of the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO analyzed data from IRS' Internal Security Management Information System to determine the (1) nature and results of IRS investigations of alleged employee misconduct and (2) extent to which data in the system was coded incorrectly.

GAO found that the system was of limited value in characterizing the nature and results of IRS investigations due to the extensive number of missing or invalid codes in such areas as the (1) locations and offices of employees who allegedly committed violations, (2) sources of the allegations, (3) types of violations, (4) administrative actions taken, and (5) results of criminal prosecution.

GAO also found that IRS (1) has not used the system's data for making operational decisions about budgets, assignments, or plans because of the system's reliability problems and (2) plans to implement a new system in fiscal year 1989 that will have validity checks to ensure input of accurate and complete data. (See p. 59 for updated information on IRS' plans.)

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**Related GAO Product(s)**

GAO/T-GGD-89-38, 7/27/89

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## **Testimony on the Reliability of IRS' Data on Investigations of Alleged Employee Misconduct**

**(GAO/T-GGD-89-38, 07/27/89)**

In hearings before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO discussed IRS' Internal Security Management Information System, focusing on the validity and usefulness of the system's data and IRS' efforts to improve the system.

GAO found that insufficient validity checks resulted in unreliable system data. Among other things, the data did not describe where many investigations took place or identify such important case characteristics as (1) the types of employee investigated, (2) IRS' administrative actions, (3) IRS' referrals for criminal prosecution, or (4) prosecutive results.

GAO noted that IRS had started developing a new system with additional validity checks to preclude incomplete or illogical data. Although the new system would apparently provide better data, GAO cautioned that (1) IRS planned to correct only some of the invalid data in the old system before converting the database to the new system; (2) IRS frequently treated cases as closed when the investigative work was done, even though final disposition had not occurred, resulting in incomplete data; (3) IRS did not know whether the new system would meet management needs; (4) requirements and computer programs needed to develop the new system had not been documented, which could cause problems in testing, operating, maintaining, and refining the system; and (5) IRS did not have a plan for periodically reviewing data accuracy.

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## **Related GAO Product(s)**

**GAO/GGD-89-13, 11/18/88**

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## Returns Processing

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### Effective Implementation of the Tax Reform Act Led to Uneventful 1988 Filing Season

(GAO/GGD-89-2, 11/14/88)

In response to requests from the Joint Committee on Taxation and the Subcommittee on Oversight, House Committee on Ways and Means, GAO evaluated IRS' (1) implementation of the Tax Reform Act of 1986 and (2) efforts to provide taxpayer service and process tax returns during the 1988 filing season.

GAO found that IRS (1) released many tax forms early for public comment and pretested forms that were significantly changed or would be widely used; (2) distributed publications, contacted taxpayer groups, and worked with a public affairs organization to inform taxpayers about tax law changes and to encourage them to file early; (3) increased the number of telephone assistants from 3,500 in 1987 to 4,500 in 1988, trained them earlier than in past years, increased the number of telephone lines by 30 percent over 1987, and increased the operating hours of telephone offices; (4) hired additional returns processing staff, reduced service center inventories to the lowest level in 3 years, and conducted extensive readiness checks at all service centers; (5) met its target date for issuing refunds; (6) met its goal of handling the increased volume of calls from taxpayers seeking assistance, and (7) generally did a good job filling taxpayers' orders for forms and publications.

GAO identified some opportunities for IRS to improve the effectiveness of future filing seasons by (1) revising sections of tax forms that were the source of numerous errors in 1988, (2) tailoring the tax package mailed to taxpayers to encourage the use of simpler forms, and (3) ensuring that taxpayers have ready access to tax forms and publications.

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### Related GAO Product(s)

GAO/GGD-89-40, 6/19/89; GAO/T-GGD-89-12, 3/16/89; and GAO/GGD-89-42, 3/7/89

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**Interest on Tax  
Refunds Paid by IRS  
in 1988**

(GAO/GGD-89-42, 03/07/89)

In elaborating on information in its report on the 1988 filing season (see p. 60), GAO provided information on the amount of interest IRS paid on taxpayers' refunds that year.

The Internal Revenue Code requires that IRS pay interest on any taxpayer refund it does not process within 45 days of the return's due date or the date IRS received the return, whichever was later. GAO said that (1) IRS generally processed refund returns first and did not begin processing nonrefund returns until after the 45-day interest-free period expired; (2) as of October 1988, IRS had paid interest of about \$12.6 million on about 1.1 million refunds, compared to \$8.3 million on about 800,000 refunds during a comparable period in 1987; and (3) of the \$4.3 million increase, about \$1.4 million was due to increased interest rates and about \$2.8 million was due to an increase in the number of nonrefund returns that IRS later found to contain errors that resulted in refunds.

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**Related GAO Product(s)**

GAO/GGD-89-2, 11/14/88 and GAO/GGD-86-72, 7/28/86

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## **Testimony on the Status of the 1989 Tax Return Filing Season**

(GAO/T-GGD-89-12, 03/16/89)

In testimony before the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' 1989 tax return filing season. GAO said that (1) its test calls to 29 IRS call sites over a 2-week period showed that IRS' accessibility declined slightly compared to 1988 while the overall accuracy of assistants' answers to individual tax questions remained about the same and (2) questions that required assistants to probe for information continued to cause the most problems.

GAO also said that (1) of the 35 IRS sites responsible for distributing tax materials to the public that GAO visited, none had available all of the 79 forms and publications that each site was required to stock and 15 were missing 10 or more of those items; (2) almost half of those responsible for managing inventories of tax materials at the sites GAO visited had not received the pertinent training; and (3) shipments of tax materials in response to mail and telephone orders GAO placed with IRS' distribution centers were frequently incomplete with no explanation as to why or indication that missing materials had been back ordered.

GAO noted that (1) although IRS appeared to be processing tax returns smoothly, some service centers had fallen behind last year's processing pace; (2) a greater proportion of taxpayers filed simpler tax forms than in 1988; (3) the percentage of filed returns that contained taxpayer errors or that IRS erroneously processed was lower than last year, but taxpayers still made many of the same kinds of errors as they did in 1988; and (4) service center case inventory levels were generally running at or below 1988 levels.

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### **Related GAO Product(s)**

GAO/T-GGD-89-13, 3/15/89 and GAO/GGD-89-2, 11/14/88

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## **Taxpayer Service**

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### **Accessibility, Timeliness, and Accuracy of IRS' Telephone Assistance Program**

(GAO/GGD-89-30, 02/02/89)

In response to requests from the Chairmen of the Subcommittee on Oversight, House Committee on Ways and Means, and the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO reviewed the accessibility, timeliness, and accuracy of IRS' Telephone Assistance Program during the 1988 filing season.

GAO anonymously placed 1,908 calls to IRS telephone assistance sites nationwide and found that (1) it was able to reach IRS on the first call 76 percent of the time and within five call attempts 93 percent of the time, compared with 61 percent and 88 percent, respectively in 1987; (2) IRS placed calls on hold 4 percent less often than in 1987, and the average waiting time decreased 29 percent; (3) IRS assistors incorrectly responded to test questions 36 percent of the time compared to 31 percent in 1987; and (4) assistors were less likely to respond accurately when the question required probing in order to ascertain all of the pertinent facts or involved recent changes to the tax law.

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### **Related GAO Product(s)**

GAO/T-GGD-89-12, 3/16/89; GAO/T-GGD-89-13, 3/15/89; GAO/T-GGD-88-47, 7/13/88; GAO/GGD-88-17, 12/3/87; and GAO/GGD-86-89FS, 6/18/86



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## **Testimony on IRS' Telephone Assistance Program**

(GAO/T-GGD-89-13, 03/15/89)

In hearings before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, GAO discussed IRS' Integrated Test Call Survey System. IRS had worked with GAO to develop this system to produce a valid measure of the accuracy of IRS' responses to taxpayers' questions in the area of individual tax law.

In its testimony, GAO commented specifically on the test call results IRS had publicly reported on March 10, 1989. As a result of those calls, IRS had reported an error rate of 30.8 percent for toll-free telephone assistance. GAO said that (1) the reported error rate was based on only the last 2 weeks of what was at that time a 4-week test and on only 29 of 62 test questions; (2) IRS used a more liberal scoring of responses than had been agreed to with GAO, without which the error rate would have been 39.6 percent; (3) many of the answers IRS considered accurate under that liberal scoring were incomplete and potentially misleading, and could lead taxpayers to make errors; and (4) IRS' failure to maintain consistent scoring standards raised questions about the validity and integrity of test results.

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## How Precise Are IRS' Estimates of Taxpayers Calling for Assistance?

(GAO/GGD-89-31, 02/21/89)

In response to congressional and administrative concerns over the amount of resources devoted to IRS' Taxpayer Service Program, GAO (1) reviewed IRS' approach for estimating demand for telephone assistance and for determining the level of telephone service provided to taxpayers and (2) compared IRS' demand estimating approach and performance measurement with that of other organizations that operate toll-free telephone services.

IRS uses telephone demand estimates to help develop budgetary projections for its taxpayer service function, determine the level of service provided to taxpayers, and manage and operate its telephone sites. IRS defined telephone demand as the estimated number of persons calling for assistance, and it defined level of service as the number of calls answered relative to the estimated number of callers. GAO said that (1) it agreed with IRS' assumptions that a portion of unanswered calls were redial attempts and that redial attempts were related to system congestion; (2) neither IRS nor GAO knew, however, the extent to which system congestion affected the redial rate or how often callers redial after receiving a busy signal; and (3) due to these and other uncertainties inherent in estimating callers, GAO could not attest to or refute the accuracy of IRS' demand estimates. GAO also said that other telecommunications organizations based their level of service on total call volume—a method that, while overstating the number of persons seeking assistance, would be useful for examining the level of congestion in IRS' toll-free telephone system and the difficulty taxpayers experienced in contacting IRS.

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## Recommendation(s)

To provide Congress information with which to more fully assess the toll-free telephone assistance program and help determine the level of funding the program warrants, IRS should provide in its budget submissions to Congress level-of-service information based on both estimated demand and actual call volume data from the prior fiscal year. This information should include the estimated number of persons calling IRS for service, the percentage of those assisted, the total call volume, and the percentage of calls answered.

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**Appendix I**  
**Summaries of Tax-Related Products Issued in**  
**Fiscal Year 1989 by Subject Matter**

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**Action(s) Taken and/or  
Pending**

IRS said that future budget submissions would include the number of calls answered, busy signals, and abandoned calls for the most recently completed fiscal year. This type of information was first included in IRS' fiscal year 1989 budget submission.

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**Related GAO Product(s)**

GAO/GGD-89-30, 2/2/89; GAO/GGD-88-17, 12/3/87; and GAO/GGD-86-89FS, 6/18/86

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**IRS' Interpretative  
Guidance  
Implementing the Tax  
Reform Act**

(GAO/GGD-89-40, 06/19/89)

In response to requests from the Joint Committee on Taxation and the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, GAO discussed IRS' provision of interpretative guidance regarding implementation of the Tax Reform Act of 1986 (P.L. 99-514).

GAO reported that (1) to implement the act, IRS developed a priority list of act sections that, in IRS' opinion, required some type of early guidance; (2) IRS' implementation plan provided for publishing 217 regulations, revenue rulings, revenue procedures, notices, and announcements, of which 174 were to be published before January 1988; (3) as of December 31, 1987, most of the regulations and all of the revenue procedures planned for publication before the 1988 filing season were still in process; and (4) some of those unpublished regulations and revenue procedures were subsequently published during the 1988 filing season, but many were still pending as of April 30, 1988.

GAO also reported that (1) as IRS gained familiarity with the act, it shifted some priorities and went on to publish by the end of April 1988 many regulations and other guidance that were not included in the original implementation plan; (2) the sufficiency of the interpretative guidance provided to taxpayers would probably not be known for another year or two, pending results of IRS audits of tax returns subject to the act; (3) IRS Internal Audit staff who monitored the 1988 filing season said they did not identify any problems that could be attributed to insufficient interpretative guidance; and (4) as a result of complaints it received after publishing a revised Form W-4 (Employee's Withholding Allowance Certificate) without obtaining public comments, IRS began obtaining broader public comments on new or revised tax forms.

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**Related GAO Product(s)**

GAO/GGD-89-2, 11/14/88

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## Tax Policy

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### Preliminary Data on Tax-Exempt Bonds Used to Finance Housing for the Elderly

(GAO/GGD-89-7, 10/14/88)

In a report to the Joint Committee on Taxation, GAO provided data on tax-exempt bonds issued to finance housing for the elderly.

By law, private organizations that provide housing for elderly or low-income individuals can apply to IRS for tax-exempt status under section 501(c)(3) of the Internal Revenue Code. Although 501(c)(3) organizations cannot issue tax-exempt bonds to finance their operations, state and local governments can issue tax-exempt bonds on behalf of such organizations if the bonds meet certain requirements.

GAO reported that (1) state and local government units must file an information return, Form 8038, when they issue private tax-exempt bonds; (2) Form 8038 does not identify the 501(c)(3) organization that will use the proceeds of the issue; and (3) because IRS cannot link particular bond issues with individual 501(c)(3) organizations, it cannot easily enforce the \$150 million limit on the outstanding bonds of an individual organization.

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### Recommendation(s)

The Commissioner of Internal Revenue should require that the employer identification numbers of the users of qualified 501(c)(3) bonds be reported on Form 8038. With such data, IRS can make computer checks by organization to ensure they comply with the Internal Revenue Code.

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### Action(s) Taken and/or Pending

IRS revised Form 8038 to require the reporting of employer identification numbers. The revised form was published on October 13, 1989.

## Deducting Interest on Funds Borrowed to Purchase or Carry Tax-Exempt Bonds

(GAO/GGD-89-14, 12/19/88)

The federal tax code is designed to tax net income—gross income minus expenses incurred in the production of that income. If a deduction for interest expense incurred to produce tax-exempt income is allowed, a taxpayer can engage in what is called arbitrage by using the deduction to offset other taxable income. Internal Revenue Code section 265 disallows the deduction of interest expense associated with tax-exempt income. The amount of disallowed interest expense is calculated in a different manner for financial institutions than for individuals and nonfinancial corporations.

In response to a request from the Joint Committee on Taxation, GAO reviewed section 265 and found that parts of it are difficult to administer, and little is known about how well taxpayers comply with this section. Specifically, GAO found that (1) although income tax forms required individual taxpayers to report tax-exempt income, IRS had no mechanism, such as Form 1099 information reporting, with which it could readily verify the amount reported and (2) because corporations were not required to separately report taxable and tax-exempt assets on the corporate tax form, IRS could not readily check whether a nonfinancial corporation was subject to the de minimus rule (i.e., if less than 2 percent of total assets are tax-exempt securities) or whether a financial institution had incorrectly applied the mechanical disallowance rule (a method of automatically allocating a portion of interest expense to tax-exempt securities).

GAO said that (1) IRS had done audits in which section 265 was an issue, but determining noncompliance given the lack of information concerning tax-exempt interest income and the subjectivity of the existing rules could be difficult; (2) evidence on the extent of individual compliance with section 265 is limited and inconclusive; (3) IRS has not studied corporate taxpayer compliance with section 265; (4) IRS officials expressed the belief that extending the mechanical disallowance rule to all corporate taxpayers would make administration of section 265 easier; and (5) the effect of extending the mechanical rule on the market for tax-exempt securities would depend on whether the rule was added to or replaced existing tax provisions.

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**Recommendation(s)**

The Commissioner of Internal Revenue should

- study the costs and benefits of requiring information reporting for tax-exempt interest income and
- consider changing Schedule L on the U.S. Corporation Income Tax Return to separately identify tax-exempt securities from other securities.

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**Action(s) Taken and/or Pending**

IRS said it would solicit information on tax-exempt interest in its Taxpayer Compliance Measurement Program. While IRS believes that this should provide some information on the usefulness of information reporting as well as compliance with section 265, IRS does not believe that the data obtained will enable management to fully evaluate the costs and benefits of requiring information reporting for tax-exempt interest income as we recommended. IRS said that it is unlikely that the financial institutions that pay this income would be willing to provide IRS the names and Social Security numbers of owners of tax-exempt securities and amounts paid because there is no legal requirement to do so.

In addition, IRS changed Schedule L on the U.S. Corporation Income Tax Return to separately identify tax-exempt securities from other types.

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## Effect of Changes in Procurement and Tax Policy on the Defense Industry

(GAO/NSIAD-89-121, 05/17/89)

In response to a request from Congressman Charles Bennett, GAO reviewed a consultant's study on the impact of selected changes in procurement and tax policies on the defense industry. The study had concluded that combined uncoordinated governmental policy changes were affecting the financial condition and operating results of defense firms to the point where it might be uneconomical to do business with the Department of Defense.

GAO noted that the consultant (1) focused on six policy changes, including tax law changes, that were implemented from 1984 to 1987 and (2) used financial data from nine defense programs to compare program performance under prior policies and to estimate the profits and cash flows that would have occurred if the new policies were in effect when each program began. The consultant reported that the policy changes would cause (1) a 23-percent reduction in profits; (2) an additional financing requirement for the nine contractors of \$8.5 billion, and (3) a lower return on investment than would be necessary to preserve shareholder value.

GAO agreed with the basic concept of the consultant's study—that the cumulative impact of policy changes should be considered before the changes are made. GAO's analysis, however, identified several problems with the consultant's methodology and indicated that the study's conclusions could not be validated for the defense industry as a whole. GAO expressed the need for a profitability reporting program that would give policymakers verified information with which to systematically analyze the cumulative impact of government policies on defense contractors' profitability.

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### Related GAO Product(s)

GAO/NSIAD-88-59, 12/02/87 and GAO/NSIAD-87-175, 09/17/87



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## Insufficient Information to Assess Effect of Tax Free Education Assistance

(GAO/GGD-89-76, 06/23/89)

In a report to Congressman Frank Guarini, GAO (1) evaluated data that the Department of the Treasury used to assess the effect of section 127 of the Internal Revenue Code and (2) assessed the availability and reliability of certain information relating to section 127. This section allows individuals to exclude from their gross income the value of educational assistance provided by an employer through an employee educational assistance program.

In June 1988, Treasury concluded that section 127, which was due to expire on December 31, 1988, should not be extended. GAO reported that the information on which Treasury relied, although the best available, was insufficient to support its conclusion. GAO explained that the information came from surveys that were not specifically focused on gathering information to evaluate the success of section 127, had low response rates, or were not representative of the population being surveyed. GAO said that (1) in 1984, Congress enacted a reporting requirement (section 6039D of the Internal Revenue Code) to provide a basis for assessing section 127, but the information required of employers was not sufficiently specific; and (2) information that would be useful in assessing section 127, such as the average income of participants and the average benefit at each salary level, was unavailable from reliable sources.

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## Recommendation(s) to Congress

When GAO issued its report, section 127 had expired. GAO recommended that if Congress decided to reinstate the provision, it might want to revise the reporting requirement to better assess the provision's effects. This could be done by requiring information on the salary level of participants and the average benefit at each salary level. To help make any further assessment of section 127, Congress could also specify that the data be reported for a sufficient length of time to adequately measure any effects.

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## Action(s) Taken and/or Pending

On December 19, 1989, the President signed the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239), which among other things, retroactively extended section 127 through September 30, 1990. It did not, however, revise the employer reporting requirement. Thus, Congress will be in the same predicament when the section expires in September 1990 as it was during past expirations because it will not have sufficient

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**Appendix I**  
**Summaries of Tax-Related Products Issued in**  
**Fiscal Year 1999 by Subject Matter**

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information to (1) adequately measure the provision's effects or (2) provide an adequate basis for determining whether or not section 127 had achieved its objectives and should, therefore, be extended permanently.

## **Costs Associated With Low Income Housing Tax Credit Partnerships**

(GAO/GGD-89-100FS, 07/10/89)

In a fact sheet to the Chairman of the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, GAO provided information on the various fees and expenses associated with real estate partnerships that use the low-income housing tax credit. GAO specifically focused on the proportion of equity financing used for fees and expenses, which would reduce the amount of equity available for actual housing construction and rehabilitation.

GAO reviewed data for each of the 19 public real estate partnership offerings on the market that used the low-income housing tax credit and, for comparison purposes, obtained information on the expenses and fees for the 48 residential or residential/commercial public partnership offerings being marketed that did not use the credit. GAO said that (1) the 19 publicly offered low income tax credit partnership projects used a higher average proportion of equity to pay fees and expenses than the other 48 partnerships—27 percent compared to 21 percent; (2) the proportion of fees that low-income tax credit partnerships spent was within guidelines promulgated by the North American Securities Administrators Association, Inc.; (3) those guidelines, which were formally or informally followed by 25 states, allowed a higher proportion of equity to be used for fees and expenses by partnerships carrying higher proportions of debt, such as is generally the case for low-income housing partnerships; (4) the 19 low income partnerships' debts averaged 76.7 percent of equity, while the other 48 partnerships' debts averaged 39 percent of equity; and (5) the amount of fees and expenses paid out of equity differed among the 19 low-income partnerships—ranging from 17 percent to 33.8 percent.

## **The Research Tax Credit Has Stimulated Some Additional Research Spending**

(GAO/GGD-89-114, 09/05/89)

In response to a mandate in the Technical and Miscellaneous Revenue Act of 1988 and a request from Congressman Brian Donnelly, GAO reviewed the structure, administration, and effectiveness of the research and experimentation tax credit. The credit, which is intended to stimulate additional research spending, allows taxpayers to reduce their tax liabilities by 20 percent of qualified research and experimentation expenditures that exceed a base amount. The base amount is equal to the taxpayer's most recent 3-year average of qualified expenditures or 50 percent of the taxpayer's current year expenditures, whichever is greater.

GAO found that (1) the credit stimulated between \$1 billion and \$2.5 billion in additional research spending between 1981 and 1985 at a cost of \$7 billion in tax revenues; (2) although the amount of stimulated spending was below the credit's revenue cost, the long-term total benefits from research could be much higher; and (3) the credit could provide more of an incentive if the moving-average base were replaced with a fixed base indexed to the growth in gross national product or another indexing factor and if the base and index were periodically reviewed and adjusted as needed.

GAO also found that (1) IRS had difficulty administering the credit and questioned the credit claimed by 79 percent of the corporations it audited; (2) many revenue agents reported that the definition of qualified research expenditures was unclear; and (3) in May 1989, Treasury issued regulations to clarify the definition.

## **Action(s) Taken and/or Pending**

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239, Dec. 19, 1989) changed the method of calculating the research and experimentation tax credit. As before, the credit applies only to the extent that the taxpayer's qualified research expenditures for the current year exceed the taxpayer's base amount. Under the new law, the base amount is the product of the fixed-base percentage and the taxpayer's average annual gross receipts for the 4 years preceding the tax year for which the credit is being calculated. The new law also prescribes methods for determining the fixed-base percentage for existing firms and start-up firms.

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**Appendix I**  
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This fixed-based method will be effective only for the first 9 months of 1990. If Congress decides to make the credit permanent, it should provide for periodic adjustments to the base as a means of reducing the amount of the credit.

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<b>Related GAO Product(s)</b>	<b>GAO/GGD-88-98BR, 6/17/88</b>
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**Other**

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**1988 Annual Report  
on GAO's Tax-Related  
Work**

(GAO/GGD-89-106, 09/29/89)

This report was prepared in compliance with a legislative requirement and contains information on GAO's tax policy and administration-related work during calendar year 1988. The report includes (1) summaries of tax-related products issued in 1988, (2) summaries of tax-related products issued before 1988 with open recommendations to Congress, (3) descriptions of legislative actions taken in 1988 in response to GAO recommendations, (4) a list of open recommendations to Congress, (5) a list of recommendations GAO made in 1988 to the Commissioner of Internal Revenue, and (6) brief descriptions of assignments for which GAO was authorized access to tax data in 1988.

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# Summaries of Tax-Related Products Issued Before Fiscal Year 1989 With Open Recommendations to Congress as of December 31, 1989

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**Congress Should  
Consider Alternatives  
to Increase Gas  
Guzzler Tax  
Compliance**

(GAO/GGD-87-85, 07/16/87)

In a report to the Joint Committee on Taxation, GAO (1) discussed the need for improving taxpayer compliance with the gas guzzler excise tax, (2) evaluated IRS' efforts to enforce the tax, and (3) identified methods for improving taxpayer compliance.

The gas guzzler excise tax, enacted in 1978, applies to domestic and imported cars manufactured after 1979 that weigh 6,000 pounds or less and do not satisfy specified miles-per-gallon ratings. To measure compliance with the tax, GAO randomly sampled gas guzzler vehicles imported through four U.S. Customs districts that accounted for about 80 percent of the independent imports from November 1983 through November 1984. Independent importers are those who import vehicles that have been manufactured for the foreign market and generally need to be modified to meet U.S. emissions and safety standards.

GAO found that (1) less than 1 percent of the independent importers paid the gas guzzler tax and (2) this noncompliance resulted in lost tax revenues of over \$6 million. IRS believed that the primary reasons independent importers did not pay the tax, besides intentional tax evasion, were that (1) many liable taxpayers were unaware of the tax and (2) some importers who were aware of the tax did not believe that it applied to them.

GAO concluded that (1) although IRS has taken actions to enforce the tax, more needed to be done and (2) achieving a more acceptable compliance level could require additional resources or a diversion of scarce IRS resources from other IRS activities.

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**Recommendation(s) to  
Congress**

As alternatives for collecting the tax more efficiently with a limited IRS resource commitment, Congress should consider (1) amending Internal Revenue Code section 4064, "Gas Guzzler Tax," to require importers to pay the tax to Customs at the time fuel-inefficient vehicles are imported or (2) amending the bonding requirement for independent importers to require proof of payment of the gas guzzler tax before the bond is released.

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**Action(s) Taken and/or  
Pending**

The Joint Committee on Taxation presented several proposals for increasing gas guzzler tax revenue in a June 1987 pamphlet that contained a listing of possible revenue sources. One of these proposals



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involved having Customs, rather than IRS, collect the tax on all imported vehicles. No further action had been taken as of December 31, 1989.

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<b>Related GAO Product(s)</b>	<b>GAO/RCED-87-29, 12/11/86</b>
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## **Congress Should Consider Amending the Social Security Act to Specify a Time Limit for Certifying Social Security Earnings**

(GAO/HRD-87-52, 09/18/87)

In a report to the Chairmen of the Senate Committee on Finance and the House Committee on Ways and Means, GAO discussed the effectiveness of the Social Security Administration's (SSA) process for crediting individuals' earnings to their individual accounts and the effect of uncredited or erroneously credited earnings on individuals' benefits and on Social Security trust funds.

Employers report employees' earnings to SSA and IRS at different times and for different purposes. IRS compares the annual total earnings reported to SSA with the annual total of the quarterly earnings employers reported to IRS. From 1978 through 1984, SSA recorded about \$58.5 billion less in employees' earnings than IRS. The amount of earnings recorded by SSA affects the size of individuals' Social Security benefits and the amount of tax revenues to which the Social Security trust funds are entitled. Therefore, differences between IRS' and VA's recorded amounts must be reconciled. GAO found that (1) SSA and IRS had not worked well together to resolve differences in employers' earning reports; (2) neither SSA nor IRS has compiled sufficient data to identify the causes of differences and the actions necessary to prevent or reduce future occurrences; and (3) SSA's plans to resolve some backlogged uncredited earnings reports did not encompass all such reports and did not include steps for addressing employers who could not or would not respond to information requests. GAO said that (1) three of every five individuals with uncredited earnings faced the possible loss of about \$17 a month in Social Security benefits and (2) unless it can certify recorded earnings for previous tax years, SSA may not be entitled to a portion of the tax revenues that it has received.

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## **Recommendation(s) to Congress**

To provide an incentive for more timely reconciliation of earnings reports, Congress should consider amending section 201(a) of the Social Security Act to specify a time limit, such as the employer earnings record retention period specified by IRS, for the Secretary of Health and Human Services to certify earnings. If Congress chooses not to specify a time limit, it should consider whether (1) SSA should be required to relinquish trust fund money to general revenue funds for those earnings amounts that employers have reported to IRS but SSA has not recorded or (2) the trust funds should be permitted to retain revenues based on IRS-recorded employers' earning reports.

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**Appendix II  
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December 31, 1989**

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**Action(s) Taken and/or  
Pending**

**As of December 31, 1989, no action had been taken.**

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**Related GAO Product(s)**

**GAO/GGD-89-21, 12/14/88; GAO/T-HRD-88-29, 8/9/88; and GAO/T-HRD-88-2, 10/15/87**

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**Congress Should  
Consider Amending  
the Internal Revenue  
Code to Permit VA  
Access to Tax  
Information for Use in  
Administering the  
Unemployability  
Compensation  
Program**

(GAO/HRD-87-62, 09/21/87)

In response to a request from the Ranking Minority Member of the Senate Committee on Veterans' Affairs, GAO reviewed the Veterans Administration's (VA) Unemployability Compensation Program to determine whether (1) veterans receiving unemployability benefits were reporting their earnings to VA as required and (2) access to tax information would enable VA to better administer the program.

GAO found that (1) 90 percent of the veterans receiving unemployability benefits, who should have reported their earnings to VA, failed to do so; (2) veterans received potential overpayments of over \$10 million during 1984 and 1985; and (3) VA rating boards used different criteria in determining marginal earnings, which could result in unequal and inconsistent eligibility determinations for unemployability benefits. Although access to tax information could improve payment accuracy, granting VA access to any tax information raises privacy concerns. Thus, GAO concluded that VA should be prepared to demonstrate that it is ready to comply with and implement privacy safeguards before access is granted.

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**Recommendation(s) to  
Congress**

To improve the VA eligibility determination process, Congress should consider amending section 6103(1)(7) of the Internal Revenue Code to permit VA access to tax data. Congress would need to weigh the potential benefits of such disclosure with (1) privacy concerns and (2) IRS concerns that expanding access in this way could affect voluntary compliance with the tax system.

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**Action(s) Taken and/or  
Pending**

While several proposals were introduced, no legislation to grant VA access to third-party-reported tax return information had been enacted as of December 31, 1989.

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**Related GAO Product(s)**

GAO/HRD-88-24, 3/16/88; GAO/HRD-85-31, 5/21/85; and  
GAO/HRD-84-72, 6/5/84

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## Congress Should Amend the Internal Revenue Code to Allow VA Access to Tax Information for Use in Administering the Veterans' Pension Program

(GAO/HRD-88-24, 03/16/88)

In response to a request from the Ranking Minority Member of the Senate Committee on Veterans' Affairs, GAO assessed VA's Pension Program to determine (1) how accurately it recorded beneficiary income, (2) the extent of overpayments in the program nationwide, and (3) whether program access to tax data was warranted.

GAO found that (1) of the 1.4 million 1984 VA pension recipients, 698,000 had their income reported to IRS and SSA by third-party sources and of those, 549,000 had \$947 million more income on their tax records than on the VA records; (2) because it did not include this income in its pension calculations, VA made potential overpayments of \$182.5 million; (3) more than 26,000 recipients reported no earned income to VA, while tax data showed earnings of at least \$1,000 each; (4) some recipients reported no earnings over several years while tax data showed significant earnings in those years; and (5) about 60 percent of the overpayments were solely attributable to unrecorded interest and dividend income.

GAO also found that (1) VA could not identify about \$157.2 million in potential overpayments because it lacked access to tax data; (2) since VA did not field-test its self-reporting questionnaires before using them, design weaknesses could have added to the inaccurate reporting; and (3) although allowing VA access to third-party-reported tax data would be the most practical way to verify income, IRS has concern that using tax data for nontax purposes may intrude into personal privacy and erode public compliance with the nation's voluntary tax system.

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## Recommendation(s) to Congress

Given the potential savings and the absence of data on potential adverse consequences to the tax system and taxpayer privacy, Congress should amend section 6103(l)(7) of the Internal Revenue Code to allow VA to access tax information so it can verify the income information that VA pension program beneficiaries report, investigate and resolve income differences, and prevent similar recurrences.

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## Action(s) Taken and/or Pending

In 1988, the Senate passed a bill amending section 6103(l)(7) of the Internal Revenue Code to grant VA access to third-party-reported tax return data to verify income and eligibility for any needs-based pensions provided under any program administered by VA. No further congressional action was taken in 1988.

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Proposed legislation to grant VA's successor, the Department of Veterans Affairs, access to third-party-reported tax return information for income verification purposes was reintroduced in Congress during 1989. The House and Senate passed separate bills providing the Department access to this tax data; but, as of December 31, 1989, no further action had been taken.

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<b>Related GAO Product(s)</b>	<b>GAO/HRD-87-62, 9/21/87; GAO/HRD-85-31, 5/21/85; and GAO/HRD-84-72, 6/5/84</b>
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## Congress Should Revise the Internal Revenue Code to Significantly Increase the Penalty for Abusive Tax Shelters and Reduce the Level of Proof Needed to Apply the Penalty for Aiding and Abetting

(GAO/GGD-88-69, 07/25/88)

In response to a request from the Joint Committee on Taxation, GAO examined IRS' legislatively mandated efforts to curtail abusive tax shelters, focusing on the effectiveness of (1) the tax shelter registration and abusive shelter detection team programs in identifying abusive tax shelters and (2) IRS efforts to administer the penalties Congress provided to curb the sale and promotion of abusive shelters.

GAO found that (1) the registration program did not provide district examination personnel with enough information to identify abusive tax shelters or to initiate investigations; (2) the detection team program did not provide district personnel with selection criteria to properly identify the types of shelter cases considered potentially subject to penalties; (3) although Congress raised the penalty to deter promotion and sale of abusive tax shelters from 10 percent to 20 percent of the gross income derived or to be derived from the shelter, promoters continued to have financial incentives for promoting abusive shelters; (4) although IRS assessed some penalties for persons who knowingly aided or abetted tax shelter abuses, it could have assessed more penalties if the law required a lesser burden of proof; (5) IRS either overlooked or incorrectly computed the penalties in 16 of 29 cases GAO reviewed in three districts; (6) IRS' computational errors totalled \$4.2 million in penalty underassessments; and (7) most of the errors occurred because IRS lacked penalty guidance, internal controls to ensure appropriate penalties, and procedures to detect errors and oversights and ascertain compliance with regulations.

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## Recommendation(s) to Congress

To reduce the financial incentive for promoting abusive tax shelters, Congress should modify Internal Revenue Code section 6700 to significantly increase the penalty above the current 20 percent of gross income derived, or to be derived, by any party involved with the promotion or sale of an abusive shelter. To reduce the financial incentive for promoting abusive tax shelters, Congress should modify Internal Revenue Code section 6701 to reduce the level of proof from knowingly to "knows or reasonably should have known" that the investor would understate tax liability to ensure that all abusive shelters are subject to penalty for aiding and abetting.

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**Appendix II**  
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**Action(s) Taken and/or**  
**Pending**

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239, Dec. 19, 1989) included, among other things, a provision to increase the penalty to the lesser of \$1,000 or 100 percent of the gross receipts derived from the promotion of an abusive tax shelter. As of December 31, 1989, no action had been taken to modify section 6701.

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**Related GAO Product(s)**

GAO/GGD-89-81, 9/6/89



**Congress Should  
Consider Requiring  
IRS to Include in Its  
Annual Budget  
Submission  
Information on Actual  
Revenues Derived  
From Audits**

(GAO/GGD-88-119, 08/08/88)

In response to a request from the Chairman of the Senate Committee on the Budget, GAO addressed two questions: (1) Can Congress rely on IRS' estimates of examination yield? and (2) Were the expected results of an increase in examination staff in 1987 realized. For fiscal year 1987, Congress had provided IRS funds to add 2,500 examination staff—an increase that IRS said would enable it to audit 120,000 more returns and assess, as a result of those audits, \$829 million in additional taxes, penalties, and interest.

With respect to IRS' estimates of overall examination yield, GAO found that (1) for each year since 1978, IRS has consistently underestimated the amount of additional taxes that its examination staff would recommend; (2) the annual underestimate averaged 28 percent over the period and ranged from about \$100 million in 1978 to about \$3.8 billion in 1986; and (3) future estimates of revenues to be gained from audits would be more reliable if IRS used more realistic assumptions—for example, information IRS was using to compute the amount of additional tax that would eventually be assessed as a result of audits came from outdated data that IRS had compiled from tracking the results of audits closed in 1972. IRS used that same tracking data to compute the “actual” assessed amounts shown in its budgets but did not disclose in those budgets that the “actuals” were really only estimates.

With respect to the yield realized as a result of the staffing increase authorized for fiscal year 1987, GAO noted that (1) IRS estimated the yield to be \$847.5 million in assessed taxes, penalties, and interest even though it did not achieve the examination staffing levels authorized for fiscal year 1987 and did fewer audits than anticipated and (2) IRS' estimate was significantly overstated because, among other things, IRS failed to take into account the amount of potential revenue lost because experienced examination staff was used to train and coach new staff and thus was unavailable to audit returns.

**Recommendation(s) to  
Congress**

Congress should consider requiring IRS to include in its annual budget submission information on the actual amount of revenues derived from its audits.

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**Appendix II**  
**Summaries of Tax-Related Products Issued**  
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**Recommendations to Congress as of**  
**December 31, 1988**

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**Action(s) Taken and/or**  
**Pending**

No steps have yet been taken to require including actual revenue in IRS' budget, primarily because IRS has yet to devise a methodology for generating such numbers. In the meantime, IRS revised the wording in its budget request for fiscal year 1990 to make it clear that the "actual" results were estimates.

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**Related GAO Product(s)**

GAO/GGD-88-16, 12/2/87

# Legislative Actions Taken in 1989 on GAO Recommendations

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Congress Extended IRS' Tax Refund Offset Program for Defaulted Student Loans	96
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## Congress Restricted Mortality Charges on Single Premium Life Insurance

(GAO/GGD-88-95, 06/14/88)

In response to a request from Congressman Fortney H. (Pete) Stark, GAO (1) examined tax policy issues arising from life insurance companies' use of higher-than-standard mortality charges to increase premiums and (2) assessed how proposals to change the tax status of investment-oriented life insurance addressed increased mortality assumptions.

GAO noted that policyholders of single premium life insurance and other investment-oriented insurance products can shelter more money for investment and have more funds available for low-cost, tax-free policy loans, since life insurance companies can (1) set premiums based on the mortality charges that they specify in the policies, (2) enhance policies' investment potential by specifying charges in excess of those normally considered reasonable for life insurance contracts, and (3) use higher mortality charges to artificially inflate premiums for individuals who are considered standard risks. In an examination of 40 single premium life insurance policies, GAO found that 8 stated a maximum mortality charge that was based on a rate of at least 2 times the standard rate.

GAO concluded that (1) recent legislative proposals curtailing the tax advantages associated with investment-oriented life insurance did not deal directly with excessively high mortality charges and (2) revision of the cash value corridor test to disqualify certain contracts from favorable tax treatment would eliminate excessive borrowing and reduce the incentive to inflate mortality assumptions.

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### Action(s) Taken

The information in this report was used in the House of Representatives' mark-up of proposed tax legislation, which evolved into the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, Nov. 10, 1988). The act, among other things, limited the ability of life insurers to specify unreasonable mortality charges in a life insurance policy.

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### Related GAO Product(s)

GAO/GGD-88-120FS, 8/8/88; GAO/T-GGD-88-20, 03/15/88; and GAO/GGD-88-9BR, 10/16/87

## **Tax-Exempt Mortgage Bonds Have Been Better Targeted to Those in Need**

(GAO/RCED-88-111, 03/28/88)

In a report to the Joint Committee on Taxation, GAO provided information on the role of qualified mortgage bonds in providing financing for single-family housing to first-time home buyers. Among the topics covered were (1) the characteristics of those assisted and (2) how those households compare with other first-time buyers. Authority for state and local governments to issue those bonds was due to expire in December 1988.

GAO found that (1) about two-thirds of the 177,786 buyers in its sample who received bond-assisted mortgage loans from January 1983 through June 1987 could have bought the same house at the same time without bond assistance; (2) assisted buyers generally had the same income, racial, marital, and age characteristics as nonassisted buyers; and (3) although about two-thirds of the assisted buyers were part of low- or moderate-income households, their median income was similar to the median income of all first-time buyers in metropolitan areas.

GAO also found that (1) the median reduction in assisted buyers' interest rate was 1.44 percent, or about \$40 per month after taxes; (2) since bond assistance did not affect factors such as the buyer's ability to purchase the home, it did little to increase affordability; (3) recent tax reform laws may narrow the interest rate differential between tax-exempt and taxable issues which could provide an even smaller increase in affordability; and (4) the federal tax loss was about \$25 million annually for every \$1 billion of bonds issued and could cost \$7.8 billion from 1989 through 1993.

## **Recommendation(s) to Congress**

GAO concluded that qualified mortgage bonds were an inefficient and costly way to provide assistance to first-time home buyers, served mostly buyers who could afford homes anyway, and did little to increase home affordability for low- and moderate-income people. As a result, GAO questioned whether the bond issuance authority should be extended.

If issuance authority were extended, however, GAO recommended that Congress consider including in the Internal Revenue Code four requirements: (1) those being assisted cannot qualify to purchase the house under conventional requirements; (2) all or a portion of the subsidy should be recaptured at time of sale (based on the extent of appreciation of house price); (3) income eligibility requirements should be adjusted

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**Appendix III**  
**Legislative Actions Taken in 1988 on**  
**GAO Recommendations**

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for the purchaser's household size; and (4) bond issuers and participating mortgage lenders should not be allowed to set aside mortgage funds for specific developers.

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**Action(s) Taken**

Congress extended the authority to issue qualified mortgage bonds through December 31, 1989, as part of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, Nov. 10, 1988). The act also tightened the targeting rules for these bonds. Among other things, it modified the income restrictions to reflect different housing costs and family sizes and provided for a recapture of a portion of the subsidy if the property is sold within 10 years.

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**Related GAO Product(s)**

GAO/RCED-88-190BR, 06/27/88

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## Congress Revised Taxation of Single Premium Life Insurance

(GAO/T-GGD-88-20, 03/15/88)

In testimony before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, GAO discussed (1) the sales, features, and tax treatment of single premium life insurance and (2) potential approaches for changing the tax-favored status of single premium life insurance products.

Single premium life insurance policies (1) allow one large premium prepayment, (2) combine death benefits with earnings, which accumulate tax-free, and (3) allow loans against the policies at little or no cost because the income on the funds offsets the interest charges. GAO found that (1) single premium life insurance sales grew 850 percent between 1984 and 1987, from \$1 billion to \$9.5 billion, while premium sales on new periodic-pay policies during the same period grew 20 percent, from \$8.3 billion to \$10 billion; (2) because recent legislation resulted in the loss of traditional tax shelters, single premium life insurance products made good alternatives to certificates of deposit and money market holdings; and (3) these policies seemed inconsistent with congressional efforts to constrain tax advantages for investment-oriented life insurance products.

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## Recommendation(s) to Congress

GAO recommended that Congress consider legislative remedies that would eliminate the tax advantage associated with investment-oriented single premium life insurance products. Two alternatives were discussed—one would treat tax loans from single premium policies as income in the year withdrawn, the other would remove favorable tax treatment from policies if loans reduced death benefits below certain levels.

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## Action(s) Taken

One intention of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, Nov. 10, 1988) was to discourage the purchase of life insurance as a tax-sheltered investment vehicle. The act created a new category of products called modified endowment contracts—any policy funded at a more rapid rate than seven equal annual premiums. The act required that loans or other amounts received from these contracts would be taxable to the extent of the interest that had built up inside the policies. Thus, single premium policies would be classified as modified endowment contracts, and loans from them would be taxable. This provision, therefore, is consistent with the thrust of GAO's recommendation.

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**Appendix III  
Legislative Actions Taken in 1988 on  
GAO Recommendations**

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related GAO Product(s)	GAO/GGD-88-120FS, 8/8/88; GAO/GGD-88-95, 6/14/88; and GAO/ GGD-88-9BR, 10/16/87
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## Congress Extended IRS' Tax Refund Offset Program for Defaulted Student Loans

(GAO/HRD-87-76, 09/30/87)

In response to a request from the Subcommittee on Postsecondary Education, House Committee on Education and Labor, GAO examined needed legislative and regulatory changes for the Department of Education's Guaranteed Student Loan Program, focusing on (1) guaranty agencies' loan collection practices and procedures, (2) ways to reduce default costs, (3) the amount of time defaulters have to repay loans, and (4) whether guaranty agencies are promptly remitting Education's share of collections.

GAO found that (1) new regulations require all guaranty agencies to standardize collection practices and follow specific actions to collect defaulted loans, (2) 1986 legislation should help to reduce defaults and increase collections by requiring guaranty agencies to report repayment patterns to credit bureaus and requiring defaulters to pay reasonable collection costs, (3) the establishment of a National Student Loan Data System should help to further reduce costs by providing means to verify eligibility, (4) new regulations require guaranty agencies to share all default payments made on reinsured loans with Education, (5) guaranty agencies allow longer repayment periods than Education and have 60 days to remit default collections to Education, (6) Education collected about \$117 million in income tax refund offsets from loan defaulters for tax years 1985 and 1986, and (7) the offset program's cost was small compared to its results.

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## Recommendation(s) to Congress

GAO recommended that Congress continue the offset program for tax years 1987 and 1988 for defaulted student loans.

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## Action(s) Taken

In the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), Congress extended the refund offset program until July 1, 1988, and required that GAO study the effectiveness of the program and report on the results by April 1989. GAO issued its report (GAO/GGD-89-60) on April 25, 1989.

On October 13, 1988, Congress passed the Family Support Act of 1988 (P.L. 100-485), which extended the refund offset program to January 10, 1994.

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**Appendix III**  
**Legislative Actions Taken in 1989 on**  
**GAO Recommendations**

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**Related Product(s)**

GAO/GGD-89-60, 4/25/89; GAO/HRD-88-52BR, 1/7/88; GAO/HRD-88-72, 8/31/88; GAO/GGD-87-39BR, 2/9/87; and GAO/HRD-86-114BR, 7/17/86

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## Congress Amended the Bad Check Penalty

(GAO/GGD-87-52BR, 3/30/87)

In a briefing report to the Joint Committee on Taxation, GAO presented the results of its review of IRS' administration of the bad check penalty. GAO's objectives were to determine (1) the number of bad checks returned to IRS by depositories, (2) the extent to which IRS assessed the penalty against taxpayers submitting such checks, and (3) the extent to which penalty assessments covered the costs of processing bad checks and assessing penalties.

GAO found that (1) IRS assessed penalties on 82 percent of the 184,000 checks that depositories returned during the first 6 months of 1986, (2) it did not assess penalties on the balance because it determined that they were tendered in good faith, (3) the deterrent effect of the bad check penalty was difficult to determine because taxpayers who submitted bad checks were also subjected to bank processing charges and other IRS penalty and interest assessments which acted as deterrents, (4) IRS processing costs exceeded the amount of the penalty assessment for about 59 percent of the bad checks it processed during the first 6 months of 1986, and (5) the 1-percent penalty for bad checks written for large amounts more than offset the costs to process checks written for smaller amounts.

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## Recommendation(s) to Congress

Since the bad check penalty had remained unchanged since 1954, GAO recommended that Congress consider whether the penalty was still appropriate and the extent it should serve as a deterrent or to recover processing costs.

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## Action(s) Taken

The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, Nov. 10, 1989) increased the penalty to 2 percent of the check's amount. If the amount of the check or money order is less than \$750, the penalty is the lesser of \$15 or the amount of the check or money order.

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# Chronological Listing of GAO Products on Tax Matters Issued in Fiscal Year 1989

Preliminary Data on Tax-Exempt Bonds Used to Finance Housing for the Elderly (GAO/GGD-89-7)	10/14/88
Managing IRS: Actions Needed to Assure Quality Service in the Future (GAO/GGD-89-1)	10/14/88
Transition Series: The Budget Deficit (GAO/OCG-89-1TR)	11/88
Transition Series: Revenue Options (GAO/OCG-89-3TR)	11/88
Transition Series: Internal Revenue Service Issues (GAO/OCG-89-26TR)	11/88
Effective Implementation of the Tax Reform Act Led to Uneventful 1988 Filing Season (GAO/GGD-89-2)	11/14/88
IRS' Data on Its Investigations of Employee Misconduct (GAO/GGD-89-13)	11/18/88
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Labor and IRS Enforcement of the Employee Retirement Income Security Act (GAO/HRD-89-32)	01/23/89
Accessibility, Timeliness, and Accuracy of IRS' Telephone Assistance Program (GAO/GGD-89-30)	02/02/89
Periodic Evaluation Needed If IRS Uses Levies to Collect Deferred Accounts (GAO/GGD-89-34)	02/14/89
Economic, Administrative, and Taxpayer Compliance Aspects of a Gross Income Tax (GAO/GGD-89-36)	02/16/89
How Precise Are IRS' Estimates of Taxpayers Calling for Assistance? (GAO/GGD-89-31)	02/21/89
Testimony on Actions Needed to Assure Quality IRS Service in the Future (GAO/T-GGD-89-6)	02/22/89
Progress in Installing IRS' Communications Replacement System (GAO/IMTEC-89-14)	02/22/89
Analysis of Proposal for Direct Deposit of Income Tax Refunds (GAO/IMTEC-89-34)	02/24/89
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Testimony on IRS' Telephone Assistance Program (GAO/T-GGD-89-13)	03/15/89
Reducing Delays in the Pursuit of Tax Revenue on Closed Criminal Cases (GAO/GGD-89-41)	03/16/89
Testimony on the Status of the 1989 Tax Return Filing Season (GAO/T-GGD-89-12)	03/16/89
Testimony on IRS' Progress in Implementing Its Electronic Filing and Communications Replacement Systems (GAO/T-IMTEC-89-2)	03/16/89
Testimony on the Administration's Fiscal Year 1990 Budget Proposals For IRS and the Tax Court (GAO/T-GGD-89-16)	04/04/89
Testimony on the Budgetary Implications of IRS' Tax System Modernization and Automated Examination System Efforts (GAO/T-IMTEC-89-4)	04/04/89
Status of IRS' Studies of the Refund Offset Program (GAO/GGD-89-60)	04/25/89
State and Local Compliance With IRS' Information Reporting Requirements (GAO/GGD-89-63)	05/04/89
IRS Needs to Assess Design Alternatives for Its Electronic Filing System (GAO/IMTEC-89-33)	05/05/89
Revenue Potential of Restoring Excise Taxes to Past Levels (GAO/GGD-89-52)	05/09/89
Testimony on the Information Return Requirements for Independent Contractors (GAO/T-GGD-89-21)	05/16/89
Effect of Changes in Procurement and Tax Policy on the Defense Industry (GAO/NSIAD-89-121)	05/17/89
Testimony on College Students' Perceptions of the Federal Government as an Employer (GAO/T-GGD-89-32)	06/19/89
IRS' Interpretative Guidance Implementing the Tax Reform Act (GAO/GGD-89-40)	06/19/89
Tax-Credit and Subtraction Methods of Calculating Value-Added Tax (GAO/GGD-89-87)	06/20/89
IRS' Automated Examination System—Troubled Past, Uncertain Future (GAO/IMTEC-89-54)	06/22/89
Insufficient Information to Assess Effect of Tax Free Education Assistance (GAO/GGD-89-76)	06/23/89
Higher Excise Tax Should Significantly Reduce the Number of Smokers (GAO/HRD-89-119)	06/30/89
Costs Associated With Low Income Housing Tax Credit Partnerships (GAO/GGD-89-100FS)	07/10/89
Statistics on IRS' Use of Levies to Collect Delinquent Taxes (GAO/GGD-89-97FS)	07/17/89

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**Appendix VI**  
**Chronological Listing of GAO Products on**  
**Tax Matters Issued in Fiscal Year 1989**

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Testimony on the Reliability of IRS' Data on Investigations of Alleged Employee Misconduct (GAO/T-GGD-89-38)	07/27/89
Results of IRS' Mid-Fiscal Year 1989 Financial Review (GAO/GGD-89-116)	08/18/89
IRS Can Improve the Process for Collecting 100-Percent Penalties (GAO/GGD-89-94)	08/21/89
The Research Tax Credit Has Stimulated Some Additional Research Spending (GAO/GGD-89-114)	09/05/89
Options for Civil Penalty Reform (GAO/GGD-89-81)	09/06/89
Missing Independent Contractors' Information Returns Not Always Detected (GAO/GGD-89-110)	09/08/89
Value-Added Tax Issues for U.S. Tax Policymakers (GAO/GGD-89-125BR)	09/15/89
The Insurance Excise Tax and Competition for U. S. Reinsurance Premiums (GAO/GGD-89-115BR)	09/25/89
Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107)	09/25/89
1988 Annual Report on GAO's Tax-Related Work (GAO/GGD-89-106)	09/29/89

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# Listing of Assignments for Which GAO Was Authorized Access to Tax Data in Fiscal Year 1989

Subject matter	Objectives
Insurance Excise Tax	To examine (1) how IRS administers the insurance excise tax, (2) IRS procedures and techniques for identifying potential nonfilers, (3) the role of tax treaties in the administration and collection of excise taxes, (4) IRS' enforcement of the tax in the United States and in treaty and non-treaty countries, and (5) industry and taxpayer data on insurers and reinsurers that do business in the United States but reside overseas.
Tax Reform Act's Effect on Shipping	To study the effect of the Tax Reform Act of 1986 on the shipping industry.
Cost to Train IRS Revenue Agents	To determine the extent to which experienced examination staff are used to train newly hired revenue agents and the cost, in terms of foregone revenue, of that training.
Partnership Tax Returns	To review (1) IRS' methodology for selecting partnership tax returns for examination and (2) the effectiveness of the examination process.
Cash Versus Accrual Accounting	To (1) evaluate the reasons why some business organizations are allowed to use the cash method of accounting as opposed to the accrual method and determine if the rationale is still valid and justified in light of the increasing budget deficit and (2) analyze the tax burden borne by those using the accrual method.



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